GRANT'S

JAMES GRANT
EDITOR

Happy and Merry

To the readers (and potential readers) of Grant's:

This compilation of recent articles, the second annual Grant's Holiday e-issue, is for you—and for your friends, co-workers, clients, classmates, shipmates, brothers-in-law and maids-of-honor, too. Please pass it along, with our compliments, to any and all prospective members of the greater Grant's family.

We resume regular publication with the issue dated Jan. 14, Vol. 29, No. 1

Sincerely yours,

James Grant

GRANT'S
INTEREST RATE OBSERVER®
Vol. 28 Winter Break Two Wall Street, New York, New York 10005 • www.grantspub.com DECEMBER 24, 2010

Money shows its age

(January 8, 2010) "It is a victory for the U.S. government," says an interest-rate strategist at Citigroup Global Markets, speaking last week of the Treasury's epic 2009 borrowing campaign. "It is a defeat for the world's investors," says *Grant's* of the very same borrow-a-thon. At auction last year, according to calculations quoted by *The Wall Street Journal*, two-year notes yielded an average of just 1.002%, 10-year notes an average of just 3.262%. Never mind flu season: For 2010, expect a pandemic of buyers' remorse.

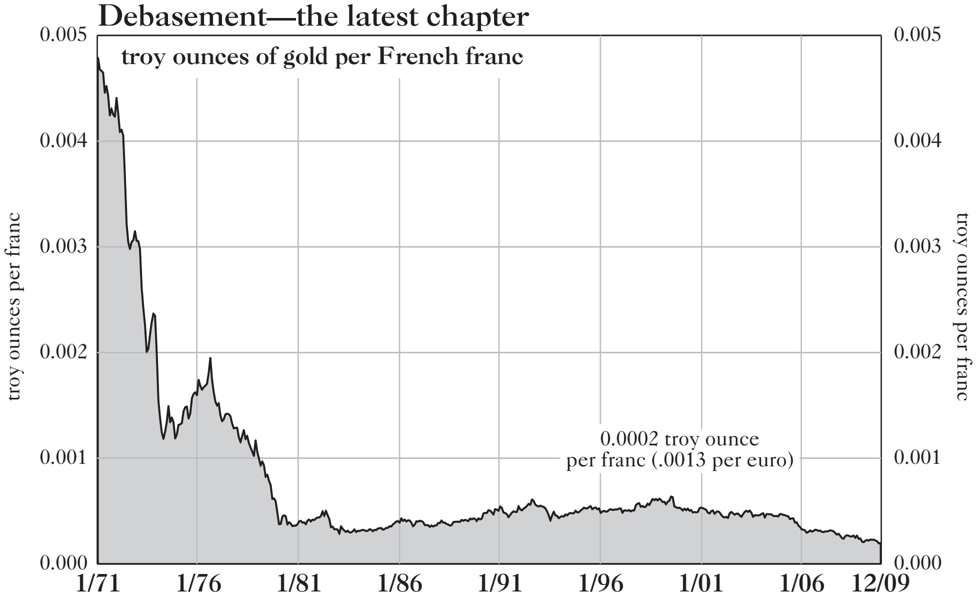
And the longer the tenor of the government security, the deeper the likely regret. Following is a pair of object lessons in the perils of government claims denominated in government money. The first is the history of a life annuity settled on a certain Frenchman and his posterity in the year 1738. The second is the story of the picking of the pockets of the owners of a charming private stone toll bridge in Oxfordshire, England. If you were thinking about banking on the promises of a government, mounting evidence suggests, think again.

The star of the French annuity saga is a lawyer named Claude Linotte (1686-1768). As he himself is beyond remorse, it falls to his many living descendants to mourn the losses that generations of Linottes have borne through the debasement of the French livre and its successor, the franc—especially the paper model franc—down through the pure paper euro of 2010. Francois R. Velde, a senior economist at the Federal Reserve Bank of Chicago, tells the story in "The Case of the Undying Debt," an essay he produced in November and is posted on Velde's page on the Chicago Fed's Web site. The article is an antidote to the kind of reflex faith in managed currencies that takes the form of bullishness toward long-dated, low-yielding government bonds.

Of Velde the storyteller, let it be said that he doesn't skimp on the details. He chronicles the history of the annuity from its origin to the present day—from the commitment by the duc de Bouillon (later, the French government) to pay Linotte and his wife, and their children and *their* children and so on until the last survivor should perish, the sum of 1,000 livres a year. And what was 1,000 livres worth in 1738? Ten ounces of gold. And what portion of those ounces has survived the succession of French fiscal and monetary disasters since the reign of Louis XV? You will not be surprised to learn that the answer is, not much.

There are stories within the story. First, the punctiliousness with which the French authorities honored their obligation to pay a stipulated nominal sum over hundreds of years. Second, the thoroughness with which the same government debased that nominal sum. As to the first, there is certainly something to like about a society that does not positively renege on its debts even as it is busily lopping off the heads of the well-to-do and waging war on its neighbors. Such was the state of France during the Terror of 1794 when Finance Minister Pierre-Joseph Cambon "found the time to engage in complex calculations and reduce the existing life annuities to actuarially fair values," as Velde writes. The Linotte annuity was among the obligations so adjusted. It received a further haircut during the

Debasement—the latest chapter



source: The Bloomberg

self-descriptively named "Two-Thirds Bankruptcy" of 1797. Presently, its value was fixed at 790 francs a year—at which it remained, except for Charles de Gaulle's 1-for-100 monetary redenomination, until the franc disappeared into the maw of European Union.

Life annuities were a standard instrument of public finance in pre-revolutionary France. You, the creditor, received a lifelong stream of interest income in exchange for your capital (Linotte's annuity has spanned many lives). When the government was especially needy, it offered "flat-rate" annuities—there was no difference in cost no matter how old, or young, the annuitant. Wide-awake Swiss bankers would select the cream of the crop of the flat-rate annuitants' pool, e.g., Geneva girls who had survived their childhood diseases and whose families exhibited a history of good health. The bankers would sell interests in a pool of 30 or 40 of these contracts to income-seeking investors, an early example of securitization.

Come the revolution in 1789, new sets of eyes examined the king's actuarial tables. The revolutionaries, though they chose not to repudiate the outstanding life annuities, did unilaterally mark down the benefits payable to claimants under 52 years of age. The sansculottes' fast-depreciating paper money, the *assignat*, was itself a kind of repudiation, of course. "In 1802," according to Velde, "after Bonaparte took power, payment in [gold] on the debt resumed; by then, the [annual interest payable on life annuities] had been reduced to 20 millions."

Because the French government issued no new life annuities post-Bastille, the population of beneficiaries necessarily dwindled. In 1880, the government paid out 109,000 francs to surviving claimants, whereas in 1886, it disbursed just 1,385 francs. By 1899, only one annuity remained outstanding, on which was paid the sum of 790 francs per year. Linotte's descendants lived.

Velde describes the confusion and irritation of the budget committee of the French National Assembly: When would they be relieved of the irksome task of appropriating those 790 francs year in and year out? The politicians directed the Ministry of Finance to attempt to buy out the beneficiaries, which the ministry proceeded to do. Would the heirs agree to capitalize the income stream at 5% and accept a lump sum of 15,800 francs? the functionaries asked. The family would not—a poor decision, it was soon revealed. In 1909, five years before the death of the gold franc in World War I, the notary representing the annuitants "informed the ministry that the family wished to keep the enjoyment of their annuity and refused to discuss any terms," as Velde writes. "This put an end to the matter, and the Assembly had no choice but to continue and vote the appropriation of 790 francs every year thereafter."

"With the opening of hostilities," Velde proceeds, "the Bank of France suspended the link between francs and gold, and part of the war was financed with large issues of paper currency. When France's Prime Minister Poincaré re-established the link in 1928, he could only do so at 20% of its pre-war parity. In other words, the owners of the Linotte rente [i.e., contractual income stream] only collected a fifth as much gold as before the war. The rente, after all, was denominated in francs, and monetary laws upheld by court decisions left the government free to decide what a franc was, and whether it would pay the 790 francs in gold or paper. This ability to substitute paper, produced at zero cost to gold, made the burden of debt lighter. The Linotte rente could well live on: inflation would slowly (or rapidly) erode it away."

As Linotte's descendants live, so does the annuity. It has, however, gone through two more changes in unit of account. In 1960, a new franc was introduced in exchange for 100 existing francs, thus reducing the annuity to 7.9 francs per year. And the birth of the euro in 1999 led to another redenomination of French currency, at 6.56 francs to 1. However, as Velde determined in a spot check some years ago, no one bothered to collect this trifle. Perhaps, the Linotte line has its pride. Their ancestor's income would, at the start, command the aforementioned 10 ounces of gold, or the equivalent of €7,793 in today's money. After 250 years of shredding at the hands of revolutionaries, democrats, socialists and central bankers, the annual income today works out to 0.0015 ounce of gold, or €1.20—"enough," as Velde wryly observes, "to buy a *café-crème* at the bistro on the way out from the Treasury."

Which brings us to that stone bridge in Oxfordshire, which opened in 1769 as a private, profit-making enterprise—and was auctioned just last month, still as a private enterprise but no longer a profit-making one. Four pence was the toll when the bridge opened under charter from King George III. An adjusted 12 pence (adjusted, that is, for the decimalization of the British currency in 1971) is the toll today. The property, consisting of two narrow lanes, a toll taker's house and contractual baggage, was hammered down in London on Dec. 3 for £1,008,000 ($1.6 million).

"The charming old stone arch bridge over the upper Thames located just west of the university city of Oxford," relates Tollroadsnews.com, "is heavily used for its two narrow lanes—over 10,000 vehicles average per day, so there is a good potential toll revenue stream. But the bridge's legal setting is an embodiment of English Eccentricity. On the plus side of the eccentricity its revenues are exempt from taxation of all kinds. On the negative side of English eccentricity the state controls toll rates. . . ." Revenue is estimated at £195,000 a year, which covers—barely—the cost of routine maintenance and the toll takers' salaries. Not a penny is available to invest in E-Z pass.

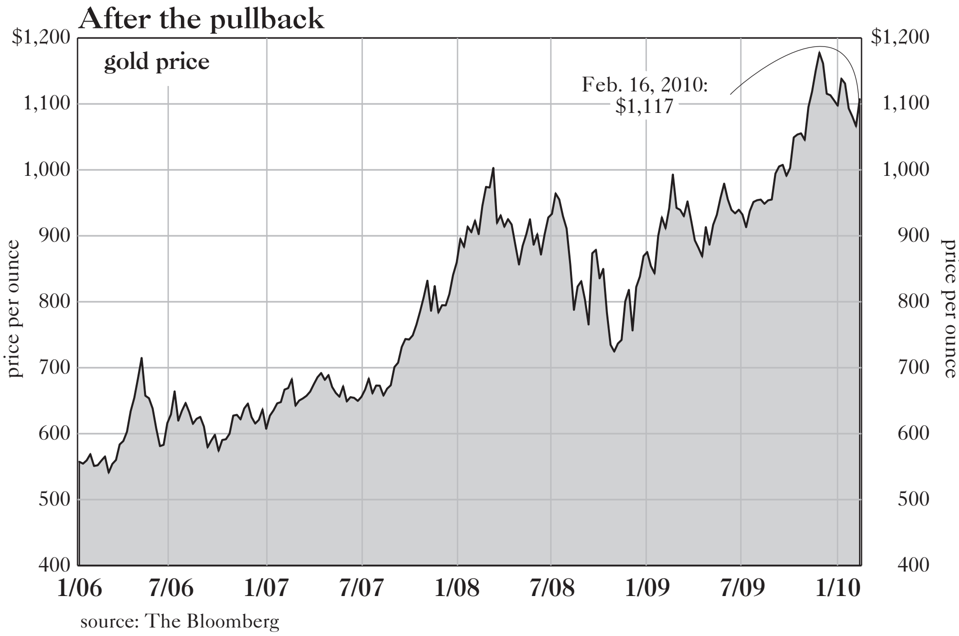
The Earl of Abingdon, builder of the bridge and owner of the sweet, perpetual, tax-free toll charter from King George III, earned a toll equivalent in today's money of £2 or so. In gold terms, the earl took in 0.00098 ounce for any "Coach, Chariot, Berlin, Hearse, Chaise, Chair, Calash, Waggon, Wain, Dray, Cart, Carr or any other Carriage whatsoever, with Four Wheels" that crossed his span. The ravages of war, devaluation and quantitative easing mean that a toll in 2010 is equivalent to 0.00007 troy ounce of gold, a devaluation of 93%.

The identity of the winning bidder for the bridge at the December auction will not be disclosed until the transaction closes, according to Tollroadsnews. However, we can rule out one possibility. Dollars to doughnuts, it's nobody named Linotte.

•

Warm thoughts on a cold metal

(February 19, 2010) Earnings season is almost over, but for GLD it never began. Not since the earth's crust cooled has the 79th element in the Periodic Table earned a dime. Yet that hasn't stopped SPDR Gold Trust, a.k.a. GLD, from becoming an institutionally recognized investment asset. Still, the question hangs in the air: What's an ounce worth?



of people who participate in the panel discussions at Davos, Switzerland. Gold may be hard to value, but you can tell it's worth something just by looking at it. The euro, too, is hard to value, but it is inherently worth nothing, absent a government to stand behind it.

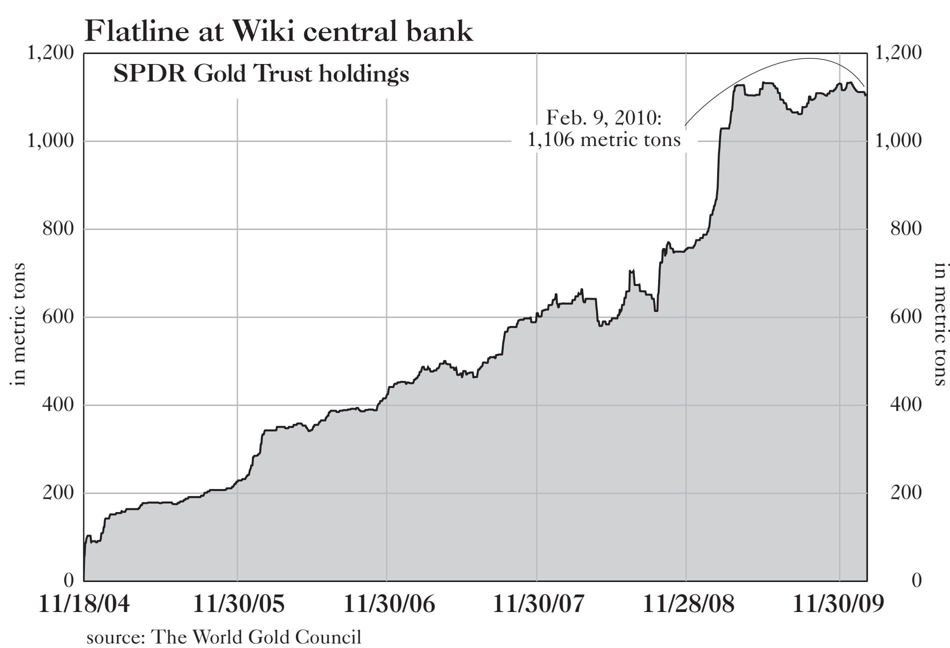
By this line of argument, the crisis of the euro should be hugely bullish for the gold price, denominated either in dollars or euros. What could be better for bullion than trouble for the made-up European money that not only circulates on the Continent but also claims a 28% share of the world's central-bank vault space (compared with 62% for the U.S. dollar)? But the euro's weakness is the dollar's reciprocal strength, and an appreciating dollar exchange rate conventionally implies a depreciating dollar gold price. Then, again, not much about this juncture in world monetary affairs is conventional.

We say we are bullish, but we have no idea where the price is going. And neither do you, whoever you are. The gold price, it has sometimes seemed to us, is the reciprocal of the world's faith in the judgment of Ben S. Bernanke. The greater the trust, the lower the price, and vice versa. You would suppose, after all the blood, sweat and tears of the past three years, that the market would not trust the chairman of the Federal Open Market Committee further than it could throw him. Yet the gold price is not $3,000 but one-third of that. It makes you humble, if you happen to be in the soothsaying business.

Now begins a reappraisal of our Nov. 27 reconsideration. That essay, skeptical in tone, ran under the headline, "Cool thoughts on a molten metal." Its thesis was not that the gold price was too high (who knows how high is too high?), but rather that its rate of rise was too fast. The central banks of India, Mauritius and Sri Lanka had very publicly bought gold instead of U.S. Treasurys. The Indian government, first of the three out of the gate, had relieved the International Monetary Fund of 200 metric tons at an average price just below $1,050 to the ounce. China must be next in line, some bulls reasoned. Others took a simpler approach to the valuation problem. The charts looked good, they said.

Then the price stopped going up and started going down—and now we're bullish again. Our approach to the valuation question is different from the chart readers' but almost as simple. Gold is a monetary asset, we reason. It competes with other monetary assets, notably with paper currencies. And it competes, too, with credit, which is the promise to pay money. In Europe, especially, gold shines brighter every day next to the competition, either to the coin of the realm or to the sovereign obligations denominated in that coin.

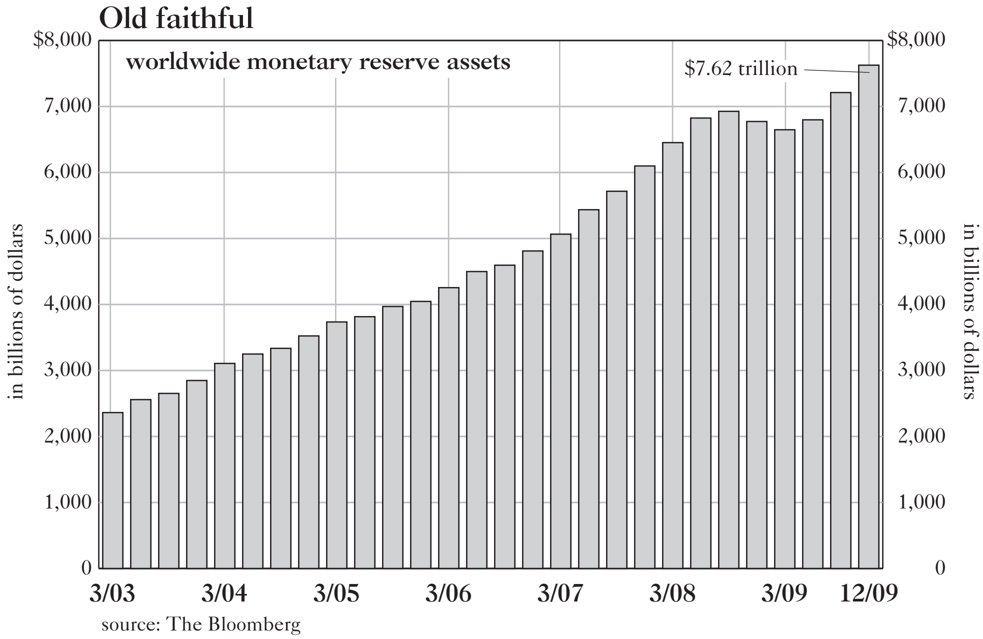
Money is intrinsically valuable, which sets it apart from credit, which may or may not be valuable. During the late crisis, people wanted $100 bills because they were worth $100. General Electric commercial paper, on the other hand, was worth par with a Treasur y guarantee, a little less—perhaps a great deal less—without one. Way back when, under our beloved gold standard, monetary value was intrinsic in the money itself. Under the law, you could exchange dollars for gold, and gold for dollars, at a fixed rate. Growth in the world's monetary base was under the control of mining engineers as much as it was of bankers. The dollar was anchored and so, to a degree, was dollar-denominated credit. But not since 1971 has any currency been so endowed. Monetary value, rather, is conferred by governments under the direction of the kind



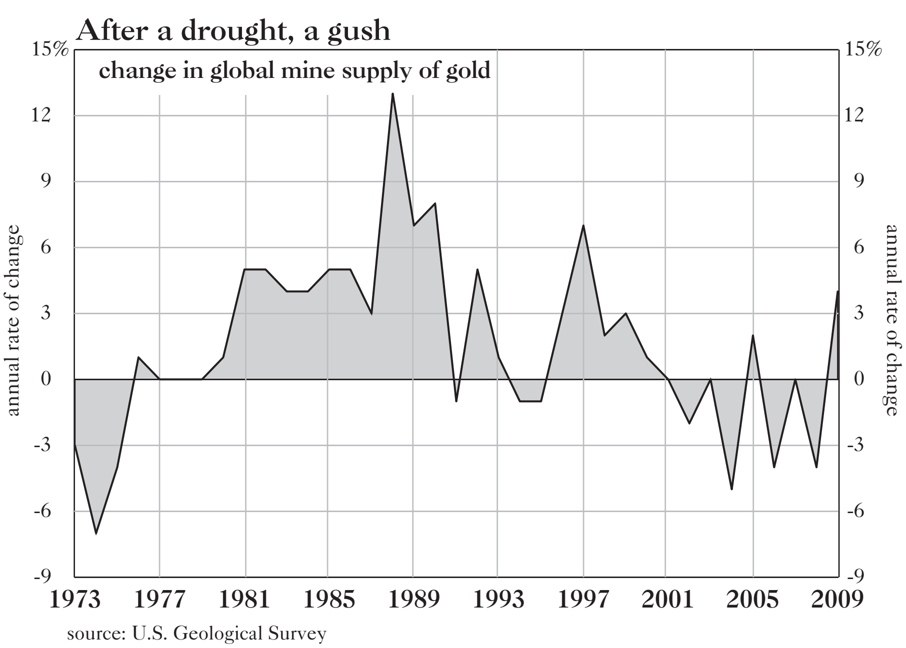
The dollar system will come a cropper, we believe, but it will evidently do so on its own schedule, not ours. Maybe the euro system will lead the way to chaos. The outer limit on the precision of our forecast is contained in the phrase, "We are bullish on gold."

The gold bull market is a decade old, but only recently has the Street begun to flatter the barbarous relic with research coverage. Trained to divine the net present value of a future stream of earnings, the analysts have cast around for a quantitative approach to a sack of Krugerrands. "Undaunted," colleague Ian McCulley notes, "the sell side, needing to fill pages with 'rigorous' analysis, has cooked up all manner of correlation and regression studies connecting the gold price to real interest rates, money supply, inflation, inflation expectations, investment demand and the dollar exchange rate. But no matter how hard the analysts try, gold still doesn't yield anything."

A recent report from one of the government-supported New York banks lays out the bearish case on the metal that used to line that institution's vaults in the days when it was independently solvent. The authors of the study—who, let the record show, were not the ones who ran the bank into the ground—argue that the gold market has lost a number of its bullish props. "Investors and speculators are the main driver of the gold price," they write. "There is no support at current prices from mine and scrap supply (which is rising), or fabrication demand (which is plummeting), in our view. U.S. dollar weakness and increased money supply has been the main driver of investment demand and speculative flows, we believe, and any strength in the U.S. dollar is the main risk to prices." And if the rising dollar exchange rate isn't bad enough, the bulls confront benign inflation, rising mine supply, a rhetorically stern Fed, a worrying swoon in U.S. monetary growth and an evident peaking in the level of gold reserves held in the London vaults of the SPDR Gold Trust.



"Wiki central bank," this publication has coined the GLD hoard. Even if no government has the courage of our convictions, any brokerage-house customer can choose to go on his or her own personal gold standard. And it seemed as if a people's gold standard were in the making during the pounding heart of the financial crisis. On the day the Fed bailed out AIG, Sept. 16, 2008, GLD held 614 metric tons; by March 2009, the stockpile had nearly doubled, to 1,127 metric tons. In dollar terms, it more than doubled in those six months, to $33 billion from $15 billion. But, lately, there has been stagnation, or shrinkage: to 1,106 metric tons at last report from a peak of 1,134 metric tons in June 2009. In point of fact, the GLD vaults have relinquished relatively little bullion compared to losses in previous bouts of gold-price weakness (thus, from March to May 2008, they surrendered 12%, compared to just 2.4% from June 2009 to this point in 2010). However, the analysts whose work we have been quoting see the vault as half empty, not half full. Investors, they contend, "are no longer concerned with counterparty risk and collapse of financial systems, but continue to want exposure [to] gold as a U.S. dollar hedge, inflation hedge and interest-rate hedge."



While we can't speak for all investors, we can speak for ourselves. We buy gold as an investment in monetary disorder. Fractional-reserve banking systems are historically prone to runs and deflationary contraction. Paper-money systems are inherently prone to inflation. Our modern financiers have created something new under the sun. They have devised a paper-money-cum-fractional-reserve-banking-system (with yet another credit structure, also highly leveraged, lurking in the shadows) that is prone to inflation and deflation at one and the same time. The greatest generation? In devising infernal financial machines, we're the one.

The United States properly takes top honors for frenzied finance, but Europe is no slouch, either. "The real problem on the Continent," McCulley relates, "is not so much the ability of France and Germany to backstop the debt of some of the weaker euro-zone sovereigns, but, rather, whether France and Germany can backstop the various exposures that their banks have accumulated. According to third-quarter data from the Bank for International Settlements, German banks have exposures of $43 billion to Greece, $47 billion to Portugal, $240 billion to Spain, $193 billion to Ireland and $209 billion to Italy. French banks have exposures of $79 billion to Greece, $36 billion to Portugal, $185 billion to Spain, $69 billion to Ireland and $489 billion to Italy. For comparison, the German banks have $625 billion of capital, the French banks, $620 billion. As a percentage of GDP, German banks' exposure to the weaker euro-zone members amounts to 22%; for the French banks, the equivalent figure is 32%. Of course, one could calculate the exposures of Citi and J.P. Morgan to California. The point is that throughout this crisis, governments have moved an ever-growing body of liabilities to public-sector balance sheets from private ones. At some point, there isn't much more debt you can pile on already overburdened national treasuries. The burden might eventually have to fall on central banks, which—unlike gold miners—can create money on a computer keyboard."

Many a discouraged gold bull is tapping his or her foot for the return of last autumn's thrilling season of central bank gold buying. Two weeks ago, when the price fell within $20 of the $1,042-to-$1,049-an-ounce range that India had paid the IMF, Andy Smith, analyst at Bache Commodities Ltd., London, raised a question: If the price broke lower, would the Indian authorities buy more? "If they don't," he replied in anticipation, "then November's purchase was more a trade than an expression of long-term intent."

So far, the gold price has forced neither India's hand nor China's. Chinese monetary authorities own 1,054 metric tons of the shiny, not-dollar monetary asset, worth $37 billion at today's prices, or 1.5% of overall foreign-exchange holdings of $2.4 trillion. So the People's Republic of China and *Grant's Interest Rate Observer* are once more at loggerheads. We are betting heavily on fractures in the world's dollar-centric paper currency system. China, on the other hand, is betting rather more heavily on stability. Then, again to judge by the recent 13-F filing of China Investment Corp., a sovereign wealth fund under the wing of the State Council, the Chinese may be reconsidering. The filing disclosed ownership of 1.45 million shares of GLD and noted further that 42% of the portfolio is invested in metals stocks.

To our mind, however, central bank buying of gold is not the world monetary authorities' main contribution to a higher gold price. Rather, they do their part just by going to work in the morning—by targeting interest rates or inflation rates or implementing what is euphemistically known as quantitative easing. Global mine supply rose by 4% in 2009, and large North American-headquartered miners are expected to boost output at a compound annual rate of 2.6% until 2016, according to data from Deutsche Bank. Compared to the 1%-per-year rate of decline in global supply since 2000, Deutsche is forecasting a veritable gusher. But no geological monetary asset has ever gushed like the paper or electronic kind. Thus, worldwide foreign exchange reserves, which consist mainly of dollars, are currently showing year-over-year growth of 16%.

Cheering, too, are signs that the gold bulls are on the defensive. At the frothy November peak, out-of-the-money gold calls were three times more expensive than out-of-the-money puts. Months of discouraging price action has bled away much of that premium. "Indeed," McCulley ends up, "now the equivalent out-of-the-money calls trade at less than two times the price of puts. The 'volatility skew,' as the options adepts express the foregoing concept, is the flattest, or most favorable towards call buyers, since the fall of 2008. It can't be said that the options market is exactly bearish on gold, at least compared to the S&P 500, where June SPY puts struck at 25% out of the money are some 15 times more expensive than equivalent calls. But the gold options market is definitely less frothy than it has been in a while. Even John Paulson's new gold fund apparently raised only $90 million, a huge whiff from the whisper number."

We don't whisper but speak out loud: Expecting monetary turmoil, we're bullish on the legacy monetary asset.

•

Buy beer, sell bonds

(May 28, 2010) To be on the safe side, just buy U.S. Treasurys. Otherwise, stocks are the ticket—stocks along with corporate credit, gold, defaulted Argentine sovereigns, Japanese net-nets, etc. "De-risking" means dollar-denominated governments, exclusively, according to the consensus of Wall Street sidewalk superintendents. "Risking" covers the other myriad investment possibilities. Price and valuation seem to make no difference in this sorting of supposed sheep and goats. It's "risk on" (go, S&P 500!) or "risk off" (onward, the U.S. Treasury 3.5s of 2020!).

We write to propose an alternative view of risk and reward. And to bring this high-minded endeavor down to earth, we have an illustrative pair trade to suggest. Long beer, short bonds, is the concept in preview.

Mr. Market delights in switching labels. When he thinks nobody's looking, he sticks the "risky" label on the "safe" asset, and the "safe" label on the "risky" asset. Yet, not infrequently, it's the supposedly risky asset that winds up preserving capital or even delivering capital gains. It all depends on price. At a price, junk bonds are gilt-edged and Treasurys are junk. At 20 cents on the dollar, subprime mortgages can be—truly, if unofficially—triple-A. More often than not, investment safety is what you find on the scrap heap.

Unhappily, in this world of zero-percent money market interest rates and hyper-interventionist central banks, investments tend not to land on the scrap heap—or, when they do, not to stay there for long. "John Bull can stand anything but he can't stand 2%," said the Victorians of the mischief that low interest rates did to investment incentives in the City of London. So, too, 125 years later on the other side of the Atlantic: Joe and Jane can't stand zero percent. They demand some return, even when consumed with fear. For them—indeed, for nearly everyone—safe harbor is the 10-year Treasury note.

As there is more than one kind of risk, so there is more than one kind of refuge. Not every hiding place is equally safe, because every market monster is different. The monster currently hiding under the bed of finance, we would say, is the threatened dissolution of the euro, i.e., a paper currency of no intrinsic value. The 10-year U.S. Treasury is a claim on the government that issues another paper currency of no intrinsic value. Neither is it monster-proof.

We say that the root cause of today's crisis is monetary. But monetary events of a certain size naturally become economic-growth events, too. The existential crisis of the euro, therefore, threatens the stability not only of currencies but also of economies, America's not least. How, then, to invest?

John Adams, not the late American president but the contemporary English academic, wrote a book entitled, simply, "Risk." It was published in 1995. "Risk," according to Adams, "is defined, by most of those who seek to measure it, as the product of the probability and utility of some *future* event. The future is uncertain and inescapably subjective; it does not exist except in the minds of people attempting to anticipate it. Our anticipations are formed by projecting past experience into the future. Our behavior is guided by our anticipations."

Total return comparison
(compound annual return)

date	7 to 10-year Treasurys	Molson Coors
12/89 to present	7.39%	9.75%
12/99 to present	6.86	6.88
12/05 to present	6.30	8.57

source: The Bloomberg

Run-ins with the monsters of 2007, 2008 and 2009 being so fresh in memory, the world is inclined to panic first and ask questions later. It panicked to the downside in 2008 and to the upside in 2009. Only time will tell if the panic of May 2010 is grounded in something more substantial than the syndrome we shall now identify as "2008-on-the-brain." Just as Adams wrote, the future is what we imagine, not what we see.

So on to the promised pair trade. Think of it as an experiment in defensive investing. On the short side are the Treasury 3.5s of May 15, 2020; on the long side is the common equity of Molson Coors, the nation's fifth-largest brewer (TAP on the New York Stock Exchange). If all goes according to your editor's vision of the "uncertain and inescapably subjective future," the bond will depreciate and the stock will appreciate. Interest rates will rise because the world will be either much worse or much better than the bond bulls anticipate. We happen to believe that the U.S. economy will be much better than the consensus imagines. Then, again, if we are wrong, and a new and even greater recession is in the wings, what would the government do in response? We suspect it would print still more money and, in so doing, stoke a new inflation, thereby giving a lift to the value of such sentient businesses as Molson Coors, which can adapt to rising prices (by raising their own) and to rising costs (by hedging).

Chartered financial analysts may shudder at comparing such different investment assets as common equity and government debt, but there are more likenesses than you might think. Most important, the dollar, like Coors Light, is a global franchise, and it waxes and wanes. It has waxed lo these many years, but—lest we forget—a not insignificant reason for the existence of the euro was the German and French abhorrence with the chronically weakening dollar of the late 1970s. Any who prefer the Treasury 3.5s at a yield to maturity of 3.16% over Molson Coors common at an earnings yield of more than 9% are tacitly registering the view that the crisis of the euro will not diminish the standing of paper currencies as a class and that interest rates, which have been falling since 1981, will keep on falling.

The 10-year Treasury note, the full-faith-and-credit obligation of a government that can materialize its own money with a computer keystroke, you already know about. Incorporated by reference is the *Grant's* model Treasury prospectus dated March 5. As for recent events, the federal budget deficit for April came in at $85 billion, according to a preliminary estimate by the Congressional Budget Office, higher than the year-ago month by $64 billion, though up by only $39 billion "after adjusting for shifts in the timing of certain payments." April receipts fell by $20 billion, or 8%, from the year-earlier month, paced by a $25 billion, or 17%, decline in non-withheld receipts for individual income and payroll taxes. The Federal Reserve did provide one budgetary bright spot. Over the first seven months of the fiscal year, it journaled $26 billion more to the Treasury than it did in the same span in fiscal 2009, "because of the central bank's shift to longer-term, riskier, and thus higher-yielding investments in support of the housing market and the broader economy." Every cloud has a silver lining.

The deficit doesn't bother the bond bulls. "The worse, the better," they say, echoing the early Russian revolutionaries. Though he intended no such thing, the director of the CBO, Douglas W. Elmendorf, might have been pitching the case for 2% long-bond yields the other day at the 35th annual forum on science and technology policy of the American Association for the Advancement of Science. Expect, said Elmendorf, a "slow" recovery, a "weak" labor market and a "low" inflation rate. And as business activity does gather strength, he asserted, the Fed will be Johnny-on-the-spot with tighter credit and higher interest rates. It was the bond bulls' prayer in PowerPoint.

Maybe the Lord will answer it. He had better for the bulls' sake, because there's not much margin for error at prevailing prices and yields. Unscripted constructive events—a respite in the European monetary crisis or a resumption of positive economic news in the United States—could scare off the fear bid. Alternatively, the coming to pass of another slump might throw into unhelpful relief the many similarities between America's fiscal and monetary ills and those of Old Europe.

Altogether, we judge the 10-year note a poor opportunity in absolute and relative terms alike. Compare and contrast an excellent relative value and a fair absolute one. At $40-and-change, Molson Coors trades at 11.2 times net income and 1.1 times book value. Following a 16.7% boost in the dividend the other day, the shares yield 2.8%. The crowd does love Treasurys, though it can't be said—yet—that it absolutely hates TAP. Give it time, we say. A few more months like the last few weeks, and the stock market itself might come to rest on the scrap heap, that pedestal of absolute value.

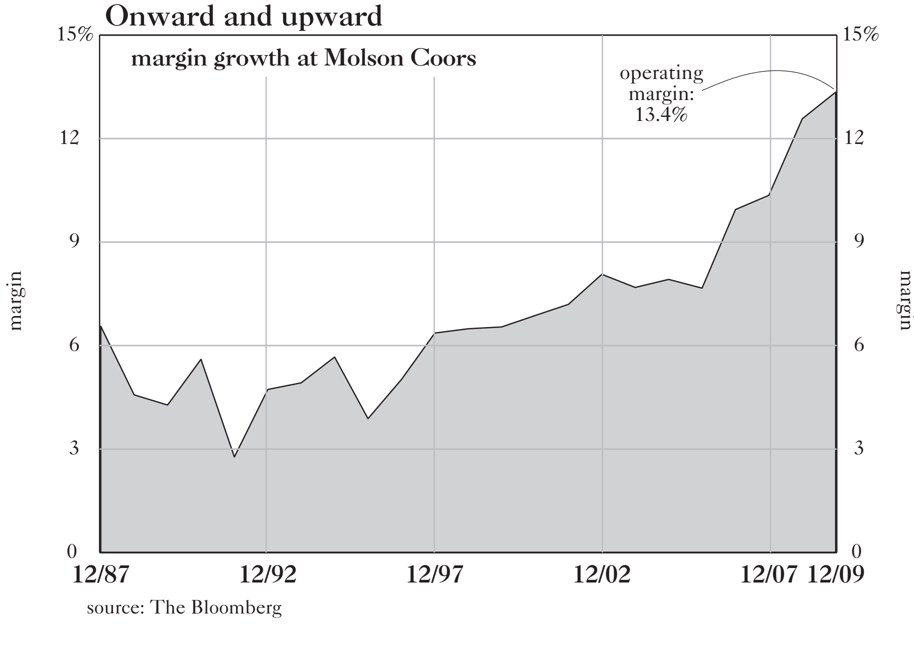
Up until the recession that shook the world, the beer business was as certain as cocktail hour. In the 10 years to 2007, American beer shipments grew by an average of 1% a year. They rose by less than 1% in 2008 and fell by 2%—virtual collapse in beer terms—in 2009, with Molson Coors suffering a 3% volume decline. Operationally speaking, Anheuser-Busch InBev, with a 1.7% decline in shipments, did better, while the U.S. Treasury did worse.

Molson Coors is the product of a 2005 merger between Canada's Molson and Colorado's Coors. A big joint venture, MillerCoors, which is 42%-owned by Molson Coors, was consummated in 2008. Miller Lite is the problem child of these unions and consolidations; its sales, by volume, fell by 4% in 2009. But five of TAP's six top brands gained market share last year. Beer sales generally have stabilized, according to Tajar Varghese, a partner of Scopia Capital, "and pricing is going to grow by another 2% in the third and fourth quarter."

Beer is easy to brew but costly to move. One reason for the superiority of the Budweiser operating margins is the excellence of that company's distribution network. Molson Coors is not about to match the scale of its larger rival, but it took a giant step toward better margins with its joint venture with SABMiller. Molson Coors management attests that that consolidation, not quite two years old, has already delivered savings through efficiencies and cost reduction—the word is "synergies"—of $359 million. It predicts that another $341 million will be realized by year 2012. You don't hear much talk about synergies from the Obama Treasury Department.

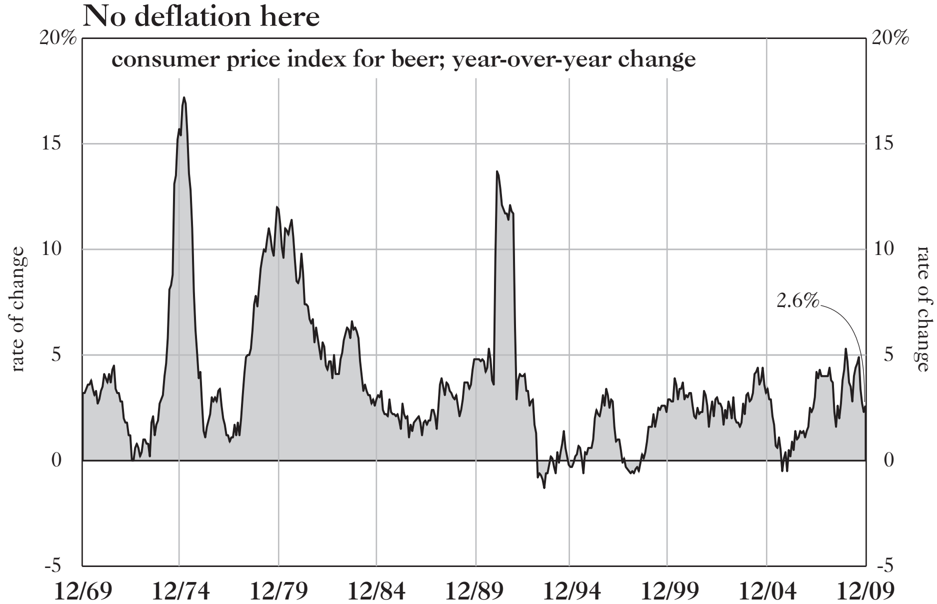
"The real kicker," Varghese tells our Dan Gertner, "is that they went through with the MillerCoors JV. That is as game changing as it gets in terms of industry restructuring. Beer is a very heavy product. . . , so logistics are everything. With this

Onward and upward



source: The Bloomberg

No deflation here



source: The Bloomberg

merger, they are going to be brewing each other's beers at a larger brewery base. So you are cutting your shipping distances in half. . . . Once they finish all of the synergies that they have planned already—and they have already increased estimates—you can get $4.50 in free cash flow pretty easily. If you assume a little bit of volume growth when the economy starts to recover, they could easily surpass $5 in free cash flow. . . . This is as stable a business as you can hope for, at least in consumer-land, and it is trading at four times the 10-year Treasury, plus you get inflation-based growth."

As it almost goes without saying, Molson Coors is heir to the ills and risks of any capital-intensive operating business. Commodity prices and exchange rates oscillate, sometimes confounding management's attempt to hedge them. The beer market is mature, and competition is fierce. However, the shares sell at a discount to the more typical mid-teens global-brewer multiple. The Molson Coors balance sheet, with a ratio of debt to equity of 1.2 times, is less heavily leveraged than any of the other top global brewing companies except Grupo Modelo S.A.B., which is debt-free.

Stock market bears may snort at the promised synergies that will allegedly drive Molson Coors' margins higher. However, if TAP is a faith-based investment, no less are the Treasury 3.5s. Bonds are inert contracts to pay dollars. Unlike the front office at Molson Coors, Timothy Geithner makes no attempt to get out in front of changing price levels and market conditions. And although he means no harm to the creditors of the United States, he's not on a mission to make them rich. To enrich the shareholders is, in fact, among the top agenda items of the executive corps of Molson Coors.

Bonds and beer each may be thought to fill a defensive need in a diversified investment portfolio. At the respective yield and earnings multiple, we judge beer the superior armor against that thing "which does not exist except in the minds of the people trying to anticipate it."

•

There'll always be a J&J

(June 11, 2010) What is a bond but a promise to pay dollars? And, not so incidentally, what is a dollar? Such musings prompted the comparison between Molson Coors, the stock, and the $3^1/_2$s of 2020, the Treasury note, in the previous issue of *Grant's*. Give us the stock, we concluded. In a similar vein, to anticipate the next 2,000 words, we've come to favor the "risky" equity of Johnson & Johnson, Wal-Mart Stores, Kimberly-Clark Corp. or ConAgra Foods over any long-dated "safe" claim on the U.S. Treasury. What's "risky" and what's "safe" is a question that time alone will answer. Ten years from now, we hazard, somebody's going to be very surprised.

To some, Treasurys are endowed with safety because the federal government can materialize dollars, whereas stocks are endowed with risk because corporations can't. To others, a "safe" asset is an appreciating one. Treasurys appeal to this kind of investor because interest rates have been falling since 1981. And while we acknowledge that there's something to be said for certainty, and a lot to be said for bull markets, it's hard to beat a good asset that's been given up for lost. As for the government's well-exhibited capacity to conjure money, we can't think of a better reason not to own government securities. Hence our preference for the above-noted, roughed-up equities. Big, stable, dividend-paying, adaptive corporations can survive in most monetary and fiscal settings. There's nothing adaptive about a bond. It never even opens a newspaper.

You may object that the investment choice is never between one long-duration asset and another—there's no law against cash. Last month in *The Wall Street Journal*, investor Seth Klarman was quoted as saying that the government is seemingly doing everything in its power to drive the public out of cash. As for the professionals, they are not so much being driven as happily driving themselves. "Carry" is the cry in the professional branch of the Treasury-speculation field. Borrowing at next to no cost to finance Treasury obligations yielding slightly more than that cost, hedge funds find that they can afford to keep the lights on, and with a little something left over.

Cash is an option on tomorrow, that thing we can't see but can only imagine. A dozen years ago, the future wore a smile. It was going to be even better than today, which was just about perfect. Now the future looks even scarier than the present, which is bad enough. Taxes are going up, the euro is disintegrating, China is teetering, Iran is acquiring nukes, unacknowledged billions of bad debts are festering, deflation is lurking (or maybe it's inflation)—you name it. One comes almost to imbibe the view that "risky" investment assets will be inevitably cheaper tomorrow than they are today. Muscle memory is adamant on the point. In the 10 years to Dec. 31, 2009, the Standard & Poor's 500 index fell by 24.1%, without regard for reinvested dividends. In the decade of the 1930s, it fell by 41.9%, also without counting the dividends. But dividends in the 1930s were substantial enough, if reinvested, to deliver a 1% annual return. The meager payouts of the '00s have delivered a 0.95% annual loss.

At Dow 9,900, and S&P 1,060, the stock market either is, or is not, cheap enough for you, value-seeking reader. The late Sir John Templeton, who came of investing age in the 1930s, defined a bargain as something quoted at 20 cents on the dollar. So may readers who cut their teeth during the value-restoration project culminating in 1974. Warren Buffett has the rare luxury of not investing when he sees nothing in which to invest. But most investors (certainly, most professional investors) take the world as it is. The question for them is not whether a certain investment is absolutely value-laden, but whether it is relatively so. Two weeks ago, we judged Molson Coors to be a commanding relative value (i.e., in comparison to the Treasury yield curve) but only a fair absolute value (i.e., in terms of the protection that the share price affords against adverse developments).

Absolute value is a thing as precious as it is rare in these days of nonstop government monetary and fiscal intervention. The springtime pullback in the S&P 500 comes nowhere close to satisfying the Templeton criterion for absolute value. But it's left some of the most storied American companies trading at the lowest price-earnings ratios in a generation.

Because "safety" is the favorite flavor, we've set out to find bond-like stocks. To wit, the equities of U.S.-headquartered corporations with market capitalizations of more than $5 billion, a return on equity of greater than 15% (for the latest fiscal or calendar year), a dividend yield greater than 2%, a debt-to-assets ratio of less than 35% and a price-to-earnings ratio of less than 15. The man inside the Bloomberg terminal produced 32 names, including 3M, Exxon Mobil and Intel, besides the ones enumerated above.

Johnson & Johnson has been around since 1887, when Grover Cleveland, a gold-standard man, was in the White House. The company grew up in the monetary turmoil of the 1890s. It survived the dollar devaluation of 1933-34 and every subsequent monetary system, including the interwar gold-exchange standard and the postwar Bretton Woods regime. On form, it will also survive the euro and the pure paper dollar.

J&J operates in 60 countries (slightly more than half of its sales come from abroad) and employs 115,500 people. In 2009, sales totaled $61.9 billion, of which the consumer segment (e.g., Listerine, Tylenol, Sudafed) contributed 25.5%, pharmaceuticals (e.g., Remicade for inflammatory disease and Procrit for red blood cell production) accounted for 36.4%, and medical devices and diagnostics (e.g., artificial hips, minimally invasive surgical products) chipped in 38.1%.

One of the drawing cards of the Treasury market is the simplicity of the bond itself. When its price goes up, its yield goes down—no ifs, ands or buts. You can be sure that you will get your interest (in dollars) and, on maturity, your principal (also in dollars). We have styled J&J a "bond-like" equity, but we are admittedly speaking poetically. Stocks are conflations of contingencies and moving parts. A product recall on April 30 (Tylenol, Motrin, Zyrtec and Benadryl at the plant in Fort Washington, Pa.) will nick a couple of cents off this year's earnings per share. The break in the euro will likewise reduce reported earnings. The Obama administration's health-care makeover is expected to reduce sales by $400 million to $500 million, and earnings per share by 10 cents, although management cautions that the costs are still being counted.

Because Treasurys have been in a bull market since 1981, they tend to get the benefit of the doubt. No such free pass is accorded these days even to the sturdiest of American corpo-

Treasury alternatives (in $ millions)

company	market cap	ROE	yield	P/E	debt/ assets
Exxon Mobil Corp.	$283,903	19.2%	2.5%	13.5x	3.9%
Wal-Mart Stores	188,673	22.8	3.8	13.5	26.9
Johnson & Johnson	161,730	27.5	3.0	12.6	13.0
Intel Corp.	118,291	15.1	2.6	14.0	4.3
Merck & Co.	104,555	30.4	4.1	10.0	17.3
Abbott Labs	72,344	27.4	3.1	12.2	32.5
United Tech Corp.	61,415	22.2	2.2	13.9	20.5
3M Co.	54,840	30.9	2.5	14.6	20.6
Kraft Foods	50,108	15.0	3.8	14.0	32.4
Altria Group	42,099	97.4	6.6	11.3	32.0
Bristol-Myers Squibb	38,796	75.0	4.7	10.9	20.5
Eli Lilly & Co.	37,650	46.9	5.4	7.3	24.6
Honeywell International	31,927	26.1	2.7	12.7	21.0
E.I. duPont de Nemours	31,485	32.4	4.4	13.4	29.0
Lockheed Martin	28,986	84.9	2.8	9.6	13.9
General Dynamics	25,508	20.8	2.0	10.7	12.4
Exelon Corp.	25,208	21.6	4.8	9.7	25.4
Kimberly-Clark	25,530	41.5	3.9	12.4	28.4
Aflac	19,853	22.0	2.1	8.4	3.0
Raytheon Co.	19,834	20.0	2.3	10.3	9.8
Chubb Corp.	16,348	15.6	2.7	8.5	7.8
Public Service Enterprise Group	15,801	18.8	4.5	9.9	28.4
Reynolds American	15,362	16.8	6.5	7.9	24.1
Air Products & Chemicals	14,287	17.4	2.5	14.7	33.0
Campbell Soup Co.	12,301	71.9	2.9	14.7	25.8
ConAgra Foods	10,894	16.1	3.2	14.0	29.7
Sara Lee Corp.	9,555	15.6	3.2	11.9	30.3
McGraw-Hill Cos.	8,714	49.2	2.6	11.1	19.0
Diamond Offshore Drilling	8,372	37.3	9.0	6.3	22.3
Mattel	7,692	26.0	3.3	13.4	16.7
Constellation Energy Group	7,095	79.9	2.7	9.3	19.4
Darden Restaurants	5,982	24.8	2.3	14.4	32.3

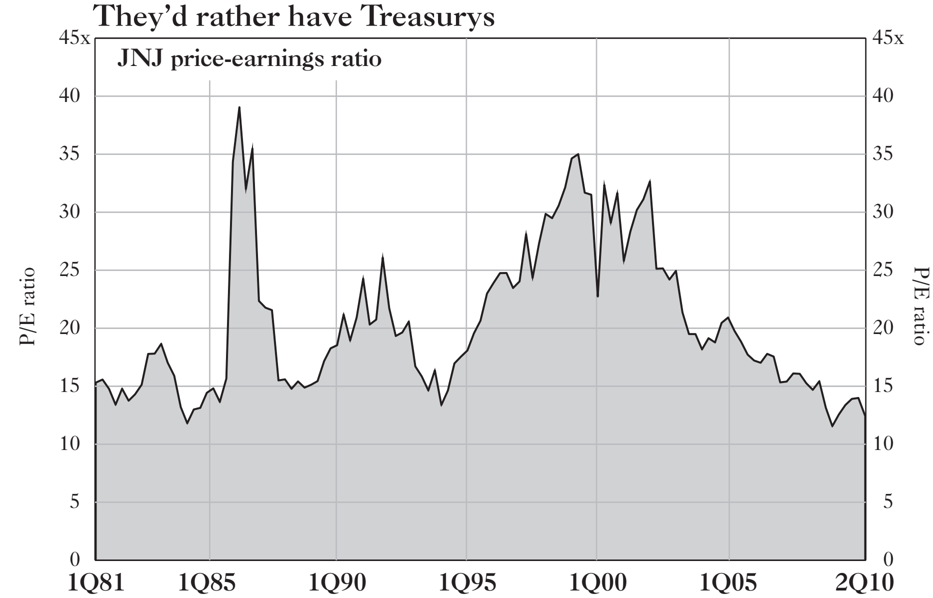
source: Bloomberg

rate oaks. On April 22, J&J raised its quarterly dividend to 54 cents a share from 49 cents. It marked the 48th consecutive year of a rising payout. Since 1980, revenues have grown by 9.2% per annum, to $61.9 billion from $4.8 billion; profit margins by 3.1% per annum, to 19.8% from 8.3%; and, dividends by 13.7% per annum, to $1.93 a share from $0.0464 a share. "In fact," observes colleague Dan Gertner, who, to disclose an interest, is a J&J owner, "anyone who bought the stock in 1980 is now earning more than the original purchase price in dividends annually.

"Since 1980," Gertner continues, "JNJ has traded at an average price-earnings multiple of 20.8 times. It is currently trading at 12.6 times trailing net income and at 12.1 times the 2010 estimate. It yields 3.7% and is one of the four triple-A-rated industrial companies left in the United States. Its market cap is $162 billion."

Wal-Mart, like J&J, is an immense, fast-growing, well-financed, world-beating enterprise that is somehow regarded by the mass of investors as a little less desirable than the 10-year Treasury. As not one of Wal-Mart's more than 8,400 retail stores is situated in Manhattan, New York readers may need an introduction to the business. The company, which opened its first store in Rogers, Ark., in 1962 and paid its first dividend in 1974, does business in 15 countries and rings up a customer someplace 200 million times a week.

They'd rather have Treasurys



source: The Bloomberg

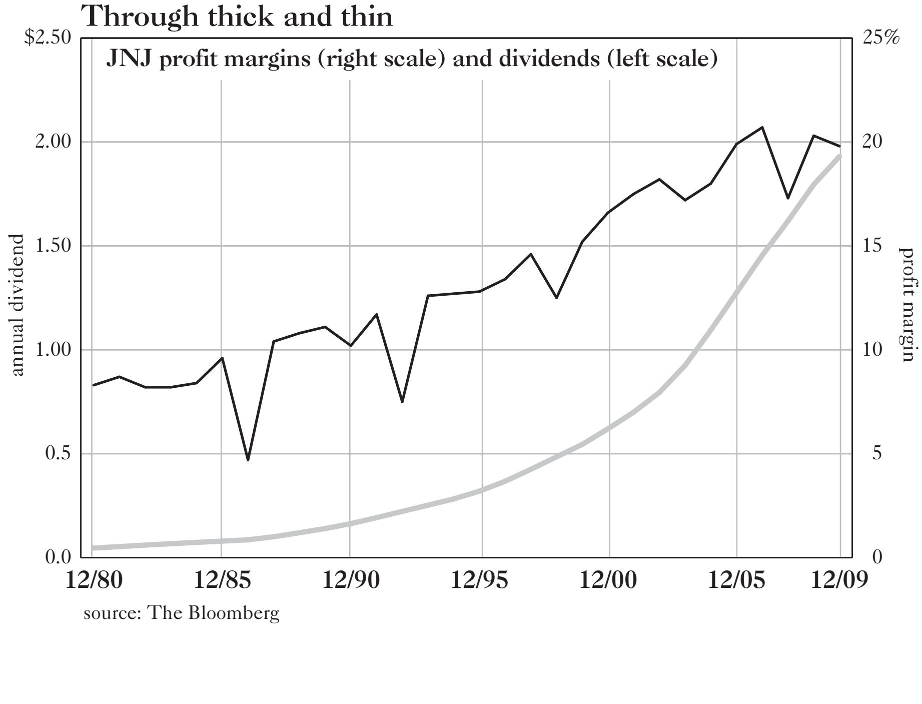
In the fiscal year ended in January, its sales topped $408 billion, of which a quarter was generated outside the 50 states. Since 1979, revenues have grown by 21.2% a year, to $408 billion from $1.3 billion. In one particular, at least, Wal-Mart management has flat-lined: For 30 years, profit margins have held steady at 3.5%.

The announcement of a $15 billion share-repurchase program was one of the highlights at the just-concluded Wal-Mart annual meeting. "During the past three years," the chief financial officer, Tom Schoewe, reminded the faithful, "our commitment to share repurchase was reflected in the company buying $18.5 billion of shares. In addition to share repurchase, Wal-Mart will pay the shareholders more than $4.5 billion in dividends during fiscal 2011."

What is Mr. Market willing to pay for this stupendous success story? He goes no higher than 13.5 times trailing earnings and 12.6 times the estimate, the all-time P/E lows. Since 1989, the shares have commanded an average P/E of 27.3 times. Understandably, a slower-growing enterprise commands a lower P/E ratio, but the Wal-Mart brain trust is talking about hiring 500,000 new employees in the next five years to complement the existing payroll of 2.1 million. The shares yield 2.4%.

Kimberly-Clark Corp. is a midget in market cap compared to Wal-Mart ($26 billion vs. $188 billion), but a graybeard in longevity. Incorporated in 1928, KMB makes diapers, tissue, wipes, feminine-care products, surgical gowns, exam gloves, face masks and infection-control products, to name a few. One of its brands, Kleenex, is a proper noun. Like our other three bond-like equities, Kimberly-Clark does business the world over. This year, for the 38th consecutive year, it raised its dividend, producing a 4.3% yield. "It's a track record we're very proud of and one we expect to continue for years to come," the chief financial officer, Mark A. Buthman, told an investment-conference audience last month. "And then with the remainder

Through thick and thin



source: The Bloomberg

of our cash, we like to give it back to our shareholders in the form of share repurchases. So since the start of the Global Business Plan [in 2004], we've taken 17% of our shares outstanding off the market and returned $7 billion of cash to shareholders through share repurchases. We're back in the market now. We'll buy another $500 million to $600 million of our shares in 2010."

KMB changes hands at 12.4 times trailing net income and 12.8 times the estimate, down from an average P/E ratio of 17 in the past decade.

ConAgra Foods (CAG on the Big Board) is smaller than Kraft or Kellogg or General Mills—Kraft also turned up on our screen but ConAgra is cheaper. It annually sells $12 billion of such staffs of life as HealthyChoice, Orville Redenbacher's, Hunt's, Hebrew National, Slim Jim, Chef Boyardee and Banquet products. In addition, it supplies fast-food restaurants with potatoes, milled grain and vegetable products. "ConAgra," observes colleague Ian McCulley, "has a little more investment juice than just being the steady-Eddie of the food business. Since 2006, it has undergone something of a transformation from what was, in effect, a holding company lacking operational focus and suffering from weak margins and low returns to a more integrated and better run business. Management claims that, since 2007, it has removed $1.1 billion of cost while improving and building the company brands, which are gaining share even in a difficult food and retail environment. As a result, margins and returns on equity, while still not at the level of some of its better-run peers, have improved dramatically. Thus, between fiscal 2006 and the quarter ended last February, operating margins have climbed to 11.8% from 7.7% and return on equity to 17.8% from 11.4%. Taking on faith the analysts' estimates for the fiscal year ended in May, sales and earnings have grown by 7.1% and 47%, respectively, since the end of fiscal 2006. Management has long-term sales and earnings-per-share targets of 3% to 4% and 8% to 10%, respectively, and thinks there are still substantial costs to be wrung out of the business.

"The balance sheet," McCulley winds up, "shows $3.5 billion of debt (of which $261 million is due in the next 12 months) against equity of $5.2 billion. That sounds high, but relative to the industry, ConAgra is actually a little lightly leveraged, with a ratio of debt to assets of 30% compared to an average of 32%. The quarterly dividend, 20 cents a share, is comfortably covered by full-year earnings before interest and taxes of $1.3 billion or so. The shares trade at 14 times trailing net income, cheaper than the historical average in the high teens (although the business is much different than it was a decade ago), and also cheaper than its peers at 16 times earnings. It yields 10% on a free cash-flow basis, and if management can keep improving margins and profitability, there seems no reason the stock can't claim a peer-average multiple. In the meantime, there's that 3.3% dividend."

Safety first, we say—and Treasurys last.

•

Back to the well for the Land of Lincoln

(July 23, 2010) "Those who are investing in the market," declared Illinois Gov. Pat Quinn on the eve of last week's sale of $900 million of Build America Bonds by the money-devouring state government, "…know our bonds have always been repaid."

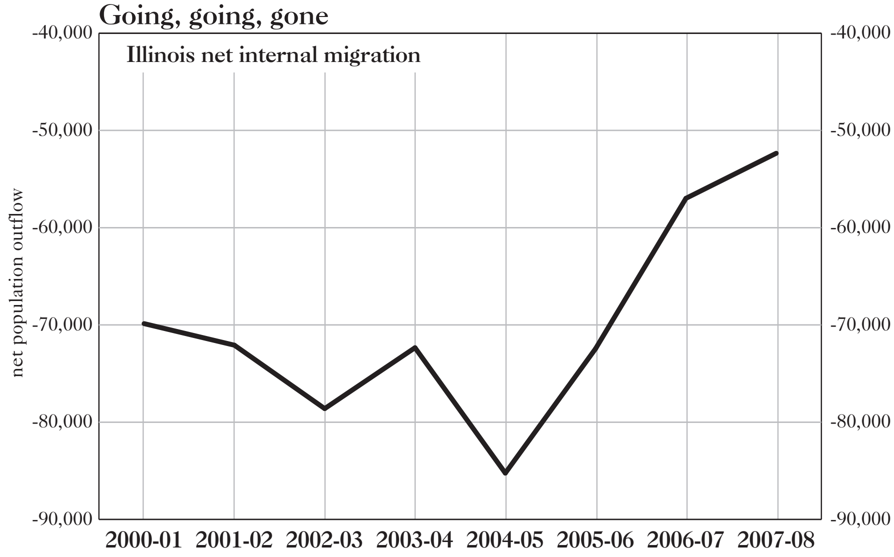
Taking Quinn at his word, the market clamored for more than twice as much debt as the state had to offer. Foreign bidding was especially keen. At the 25-year maturity, securities were priced to yield a taxable 7.35%, or 325 basis points more than long-dated Treasurys; at the 10-year maturity, they fetched a taxable 6.2%, or 310 basis points over the curve. The United States may be more fiscally problematic than even the state of Illinois, but the government in Springfield possesses neither an A-bomb nor a central bank.

Now begins a brief sequel to our more than brief arraignment of the municipal bond market two issues ago. Illinois—past, present and future—is the featured subject. In preview, while we have no interest in the state's debt when the yield to maturity is in the neighborhood of 7%, we would be willing to reconsider at 43¾%—at which level, in fact, it traded in New York during an earlier crisis of American public finance. The conviction here is that, while the past isn't necessarily prologue, it's usually pertinent.

Not that the tax-exempt market is thinking about history, or, for that matter, credit. Municipal bond funds this month topped $500 billion in assets for the first time. And closed-end municipal bond funds, leveraged with preferred stock, are the standout closed-end performers of 2010 (with premium valuations to match).

The burden of our bearish case was that, at prevailing yields—all of 2.79% on 10-year double-A-rated bonds, at the moment—tax-exempt investors are going uncompensated for the marked deterioration in state and local creditworthiness. And we do recall writing, on another date, words to the effect that, while Europe has its Greece, America has its California (we should have said Illinois). "The statement that any U.S.

Going, going, gone



source: The Brookings Institution

state is the next Greece, meaning a near default on their bonds, is not based on fact," Bloomberg quoted an analyst at Samson Capital Advisors as saying on July 12. While Greece's ratio of debt to GDP reaches 113%, the analyst noted, the median debt-to-GDP ratio of the 50 states is but 2%.

Maybe we can find some common ground with our critics. Yes, the 50 states are relatively lightly encumbered compared to the likes of Greece, Spain and Portugal. But while the average Greek, Portuguese and Spaniard would think long and hard before emigrating, a productive Illinoisan might just call Allied Van Lines. Between 2000 and 2008, Illinois ranked 46th out of 50 states in net in-migration. Only New York, Michigan, Ohio and Louisiana saw a smaller net human inflow. Illinois has a 3% flat-rate income tax and a 6.3% sales tax. Its median property-tax assessment, $3,384, is the nation's seventh highest. If in trying to close the state's yawning budget gap or refresh the state's desperately underfunded pension funds, the governor prevailed on the legislature to thrust the hand of the state even deeper into private pockets, how many productive Illinoisans would pack up rather than pay?

Fewer than you think, the bulls reply. Chicago is the golden goose of the state of Illinois, and the goose has more lives than a cat. "Overtaxed? Feeling Ill.? Come on In.," said the billboards posted by Indiana's economic development team to tease a great Illinois business or two across the border. Word is that the campaign drew only smiles (nor is it even clear that Hoosiers pay less than their neighbors). Chicago has a hold on people. Illinois only looks broke, the argument goes. It will never stop paying its bondholders.

That it did, in fact, once default on its interest payments to bondholders is a story of more than historical interest. The year was 1842, and Illinois, along with other American states, was deep over its head in bonded debt to finance the construction of canals and railroads. The state legislature had authorized borrowing to build 1,300 miles of railroad and 102 miles of canal, the latter connecting the Illinois River (and thus the Mississippi) to the Great Lakes. "All this breathtaking ambition soon distinguished the project as one of the 19th century's best object lessons in the folly of state capitalism," in the words of colleague Adam Rowe, who continues:

"The state's bankers had expected their extravagant project to pay for itself. Pleased with this notion, they seemed to have forgotten that all the money would be going out before any of it came back in. By 1840, three years after the borrowing started, the state had spent all the money it raised and had just 24 completed miles of railroad to show for it.

"Most Eastern states with similar debt issues in this period raised or implemented property taxes to avoid default. But all Western states, including Illinois, were unwilling or unable to do so. Illinois, whose undeveloped frontier economy presented few alternatives, already relied heavily on property taxes. More importantly, the state was competing for Western settlers, who had swelled its population from just over 50,000 in 1820 to nearly half a million in 1840. A heavy tax burden could obviously be expected to end this boom. And the state's highly mobile population (Western residents were twice as likely to move as those in the East) were not likely to stay put a minute longer than it made financial sense to do so."

The way forward, the governor of Illinois, Thomas Ford, decided, was to complete the canal the state had already started to dig (as for the railroad, it was a dead loss). Five million dollars had already been sunk; it would cost another $1.6 million to finish the job. The thing to do was borrow the money. But from whom?

In a report for the just-ended 2010 fiscal year, the state comptroller, Daniel Hynes, alluding to a general fund balance of minus $4.7 billion, made bold to claim that Illinois is "in the worst fiscal position of its history." He should have been around 168 years ago. Nowadays, Illinois owes $13 billion, just 2% of 2008 state GDP; then, the debt totaled $13.5 million, or 43.4% of state GDP. On a per-capita basis, the state owed $28.42 against GDP of $65.43, or, in today's dollars, $721 vs. $1,660.

When Illinois went hunting for takers for its Build America Bonds of 1843 or thereabouts, foreigners had every reason to turn their backs. Mississippi and Florida had repudiated their debts in 1842. As for Illinois paper, it was trading at the aforementioned 40%-plus yields. Nevertheless, Baring Brothers and Magniac, Jardine & Co., after some chaffering on taxation, collateral and the appointment of suitable trustees, agreed to front the funds, and the canal was completed in 1848.

What can that distant episode teach us moderns about the vicissitudes of public finance? No. 1, extract a suitable rate of return for the risk. No. 2, position yourself on the correct side of the growth curve. "In 1837," Rowe winds up, "when construction on the Illinois and Michigan Canal began, the Illinois legislature also granted a city charter to an insignificant settlement named Chicago, where the planned waterway would open into Lake Michigan. The canal completed an internal water route from New York to New Orleans. Not even the most overzealous promoter of the project could have overstated the promise of the future they were building. The state had hoped to establish the transportation hub of the West, and it succeeded beyond the dreamiest of expectations. With their eyes fixed on this sunny horizon, however, the state's leadership fell headfirst into a ditch directly under their noses.

"Today, the problem appears to be the exact opposite. With the worst underfunded pension problem in the country, Illinois faces an increasingly gloomy horizon, while the state leadership keeps its eyes trained on the ground immediately before it. The ditch seems to be the destination, rather than an obstacle, and the path to it remains only too accommodating."

•

Certifiably formerly toxic

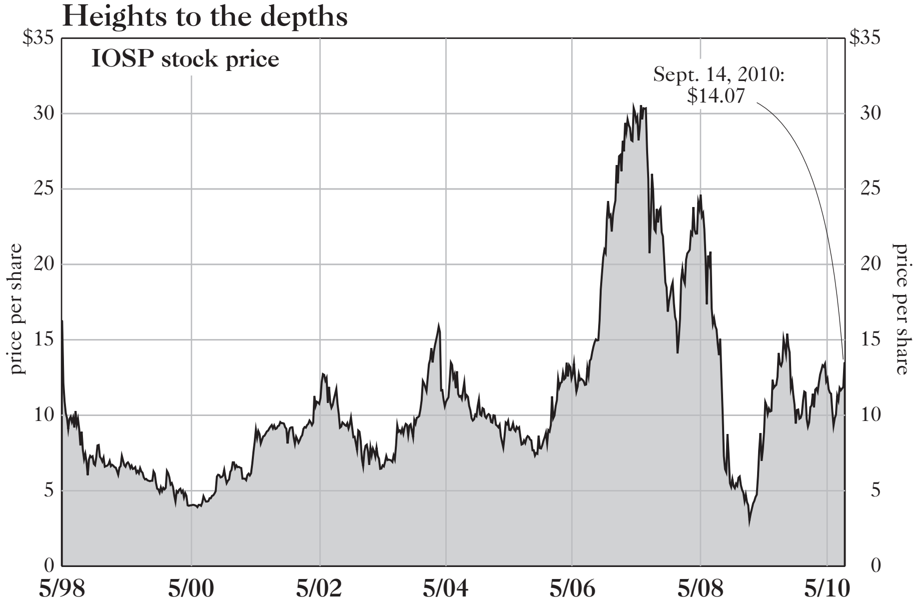
(September 17, 2010) Innospec Inc. is the subject at hand. That is, "[c]orruption-tainted chemical firm Innospec" or "[b]ribery firm Innospec," as a British newspaper has characterized the U.K.-headquartered, Nasdaq-listed maker of a certain toxic compound. These days, a major stockholder seems to want out of his IOSP position, and demand for the company's anti-knock fuel additive used in leaded gasoline since the time of the Model A Ford—TEL, for tetra ethyl lead—is vanishing. And, as if that weren't enough, sell-side coverage is virtually nonexistent. In preview, we're bullish.

We were bullish, too, at the beginning. Begat in a 1998 spin-off from Great Lakes Chemical Corp. (or Chemtura, as Great Lakes was rebranded after the consultants finished with it), Innospec was christened Octel Corp. "Hate the product" was the headline over our bullish review in the issue of *Grant's* dated Dec. 4, 1998. The gist of the analysis was that the new company could generate enough cash to pay down its debt and repurchase its 14 million shares of stock before TEL was regulated out of existence. Little did we know to what lengths management would go to delay the inevitable. Among the crimes to which it confessed in March were those of bribing the Indonesian government, breaking the U.S. embargo of Cuba and paying kickbacks to Saddam Hussein's Iraq under the United Nations Oil-for-Food Program. Back in 1998, we explained away our failure to coax the senior officers to the phone for an interview with a line that today seems not so much lighthearted as air-headed. "As we are bullish," we cheerfully wrote, "we will rationalize this disappointment with the thought that the Octel brass are engaged in no activity except the maximization of shareholder value." Well, yes, in a way.

It's an integral part of the Innospec story that the company's March plea deal with the U.S. and U.K. authorities was accompanied by a management shuffle. Out went the incumbent CEO, Paul Jennings, and in came his successor, Patrick Williams, formerly president of one of the company's non-TEL divisions (and uninvolved with the extracurricular marketing activities, it appears).

That the non-TEL businesses are coming on strong is another integral part of the Innospec story. The largest of the company's three operating divisions makes non-TEL chemical additives to mix into fuels to boost engine performance and reduce exhaust emissions; over the past 12 months, it accounted for 67% of sales and 71% of gross profit. Until 2004, growth in the additives group had come mainly from acquisitions. Since then, however, 43% of its sales have derived from home-grown products. Competitors "can't produce our products," CEO Williams tells *Grant's*. And he adds: "This is an incestuous business. A lot of our competitors

Heights to the depths



source: The Bloomberg

Inside Innospec
(in $ millions, except per-share data)

	12 mos. to 6/30/10	2009	2008	2007	2006
Net sales					
Fuel specialties	$434	$423	$441	$375	$311
Active chemicals	145	130	138	134	120
Octane additives	67	46	61	94	100
Total	645	599	641	602	532
Gross profit					
Fuel specialties	145	147	146	125	106
Active chemicals	31	27	13	25	23
Octane additives	29	15	28	48	58
Total	205	189	186	197	187
Operating income					
Fuel specialties	79	81	80	64	46
Active chemicals	13	9	(5)	6	6
Octane additives	(17)	(45)	1	20	35
Pension charge	(9)	(6)	(2)	(5)	0
Corporate costs	(21)	(13)	(25)	(22)	(22)
Restructuring	(10)	(3)	(2)	(3)	(5)
Impairment	(2)	(2)	(4)	(12)	(37)
Profit on disposal	0	0	0	0	9
Total operating income	33	21	44	48	32
Other income	(1)	4	(19)	7	7
Net interest expense	(5)	(6)	(5)	(7)	(7)
Profit before tax	27	18	19	48	32
Taxes	11	12	6	18	20
Net income	16	6	13	30	11
EPS	$0.65	$0.26	$0.51	$1.19	$0.90

buy products from us either because of patents or our scale." The business, Williams explains, is broadly driven by "legislation and engine technology." With disruption from either source, refiners must buy new additives to meet new specifications. Nelson Christian, manager at CountryMark, an independent oil refiner in Indianapolis, tells our scout that the rising price of additives tops his list of business worries. "I don't know how many competitors there are today compared to five years ago," Christian says, "but it feels like there are fewer due to mergers and acquisitions."

Innospec's Active Chemicals division (22% of sales and 15% of gross profit over the past 12 months) had been the corporate problem child. As recently as 2008, it was showing $5 million a year in losses; over the last 12 months, it has delivered $12.5 million in operating profit. Surfactants are its principal stock-in-trade. As every former chemistry student remembers, surfactants are compounds that, by lowering the surface tension of water, may act as a detergent, emulsifier or foaming agent—one that, for instance, puts the bubbles in shampoo. The company's new Cadillac product, a surfactant called Iselux, contains none of the carcinogens that commonly turn up in the alternative brands; customers seem not to miss the 1,4-dioxane and sulfates at all.

As for Innospec's legacy TEL business, it chipped in 10% of sales and 14% of gross profit over the past 12 months, as the company has the market all to itself. Even adjusting for non-cash goodwill write-downs and legal expenses, there's money in it yet. That it's shrinking all can see. When it might disappear is another question. "Four years ago," Williams tells *Grant's*, "we would have thought we would have exited this business by 2011. TEL does what it does. It hits the octane needed in aviation. I don't think that will go away until 2020 at a guess. Mogas [motor gasoline]—we thought we would be out by 2010, but that business will last another four to five years."

"Although the financial magnitude of this settlement is significant," Williams said at the time of the company's March plea bargain, "our ability to deliver on Innospec's long-term business strategy remains strong and I look forward to the future with great optimism." The exact financial magnitude—$40.2 million in fines, penalties and disgorgement of profits, payable over four years—may have seemed steep to the stockholders (it was greater than operating income in two of the past four years), but it left at least one British jurist muttering that the company got off scot-free. Be that as it may, Innospec reserved for the full amount in the third and fourth quarters of 2009.

With the lifting of that particular concern, another remains, and Tontine is its name. According to a 13D filing in November 2008, Jeffrey Gendell, general partner and founder of Tontine Associates, a Greenwich, Conn., hedge fund, had accumulated 20.5% of IOSP's

Innospec vs. the field

company	ticker	EV/ sales	EV/ EBITDA	EV/ EBIT	P/E	P/FCF	P/B
Innospec Inc.	IOSP	0.7x	7.8x	12.6x	21.6x	6.2x	1.9x
Fuel specialties							
Lubrizol Corp.	LZ	1.4	5.8	5.5	10.4	10.8	3.2
NewMarket Corp.	NEU	1.0	5.1	4.9	8.5	21.3	3.4
Albemarle Corp.	ALB	2.0	10.3	12.6	14.7	12.3	3.2
Avg.		1.5	7.1	7.7	11.2	14.8	3.3
Active chemicals							
Givaudan S.A.	GIVN VX	2.6	12.7	18.4	27.7	23.8	2.5
Int'l Flavors & Fragrances	IFF	1.8	9.5	10.5	14.9	15.0	4.4
Stepan Co.	SCL	0.5	3.9	6.6	9.4	12.1	1.9
Avg.		1.6	8.7	11.8	17.3	17.0	2.9

sources: The Bloomberg and company reports shares (a suitable marriage of fund and investee, it seems, as the TEL market was a kind of tontine, with Innospec having outlived all the other competitors to become the sole producer). Owing to losses suffered in 2008, however, Gendell was obliged to liquidate his positions, including the chunky one in IOSP. As of his latest filing, on Sept. 10, Gendell had reduced his holdings to 14.4%, or 3.4 million shares. That he may have to sell them all is the invisible hammer over the share price. (A spokesman for the fund declined to comment.)

So much the better, we say on behalf of that rare and hardy breed, the low-frequency trader. On the face of things, Innospec may not look like a bargain at 21.6 times earnings and at a ratio of enterprise value to EBIT (earnings before interest and taxes) of 12.6. But that is where the valuation story begins, not where it ends. In the past 12 months, Innospec generated $35 million, or $1.38 a share, in earnings before interest and taxes. And that was after reserving for that $40.2 million in settlement charges and $8.2 million in non-cash charges to convert the corporate pension plan from defined benefit to defined contribution. Abstracting from those two items alone, the shares would trade for 5.2 times EV to EBIT. On the basis of price to free cash flow, IOSP, at 6.2 times, is considerably cheaper than the companies to which it may be fairly compared.

To hear management talk, it's determined to bring itself and its stock out of the shadows. On the second-quarter call, Williams said that the company will "step up our investor relations program significantly in the second half" and that it has "begun looking aggressively at a variety of strategic alliances and acquisition opportunities." As the company had once paid a dividend and repurchased stock, Williams indicated that such share-price-enhancing stratagems are back on the table again. Asked to elaborate, Ian Cleminson, the CFO, tells *Grant's*, "We want a balanced capital management program. We are willing to put our dollars into acquisitions, dividends and buybacks. Most important to us is organic growth. We will invest in Iselux. We will invest in acquisitions as well. If the time is right, we will do a buyback. We will do that on a contained basis. A dividend is probably further down the line given tax changes in the U.S." Elaborating in turn, Williams adds, "We've looked at four deals in the last four months but multiples are outrageous. I'd rather buy back my stock than overpay for a business."

In our conversation with Williams, we asked if the company is for sale. "We want to do what is best for our shareholders," the CEO replied, "but we feel comfortable with our strategy. We think we will get greater value by executing our strategy in the next three to five years than being bought out in the next 12 months." "We are undervalued," Cleminson added. "If someone came in right now, it would be a bid off a low base."

Deeds underscore words in this regard. In 2010, the insiders (hedge-fund manager Gendell excluded) have sold no shares but have laid out $613,777—in cash, no less—to buy them.

•

Patience of a saint

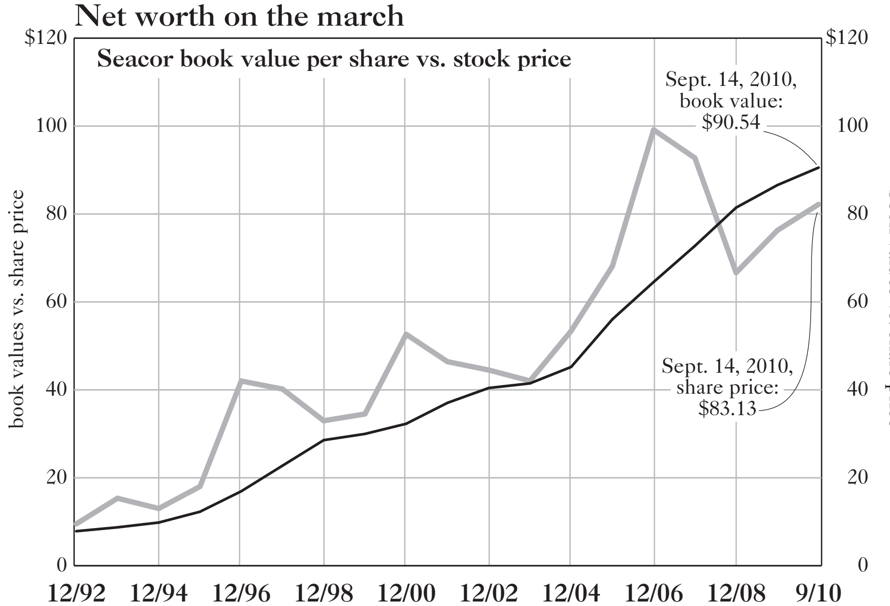
(September 17, 2010) Seacor Holdings (CKH on the New York Stock Exchange) is not quite an analytical orphan—Barclays Capital follows the stock—but Seacor management probably wouldn't mind if nobody were paying attention. Buying in as many shares as it does, and hewing to an investment horizon as long as its chief executive's, the company can be said to have a rooting interest in a low stock price, rather than a high one.

Now unfolding is a bullish review of an operating business that might as well be called an asset-management business. Seacor owns and operates workboats, inland barges, helicopters and oil tankers. It doesn't just sit in front of a Bloomberg terminal; rather, it thinks as long and hard about how to trade these assets as it does about how to operate them. "I personally believe," Charles Fabrikant, Seacor's chairman, CEO and a top-six shareholder, advised his fellow shareholders in 2007, "that buying and selling equipment is as core to our activities as renting assets by the day, month or year. One might analogize to an investment portfolio where dollars earned from capital gains and dividends are equal."

To declare an interest, Fabrikant is a subscriber to *Grant's* as well as an investor in a *Grant's*-managed enterprise. By reason of these associations, your editor wouldn't dream of writing a bearish piece on Seacor or its guiding light. Nor had he contemplated a bullish one until CKH popped up on the *Grant's* orphans' screen. With $1.7 billion in stock-market capitalization, Seacor is among the largest companies in the universe of analytically neglected stocks.

Large—and unusual, too. Remarkable, for instance, is management's demonstrated knack for doing what it sets out to do. To earn a rate of return two to three times that of intermediate-term, A-rated municipal bonds without excessive leverage is near the top of the list of these corporate undertakings. Of course, your aunt's investment club could beat today's muni yields, but it wasn't so easy when Seacor went public in 1992. In

Net worth on the march



source: The Bloomberg

Seacor—sum of the parts
(in $ thousands)

	segment profit/loss	average assets	segment profit/ loss return
Offshore Marine Services	$128,631	$895,379	14.4%
Marine Transportation Services	2,673	366,711	0.7
Inland River Services	40,582	434,355	9.3
Aviation Services	23,574	672,118	3.5
Environmental Services	85,076	267,717	31.8
Commodity Trading and Logistics	(6,504)	104,067	-6.2
Other	8,899	224,826	4.0

* for 12 months ended June 30, 2010

that distant day, high-grade tax-exempts fetched $5\frac{1}{2}$%. Over the subsequent 18 years, Seacor's book value per share climbed to $90.54 from $7.84, or at a compound annual rate of 15%. Not once in that time did the company show an annual net loss, and never did it borrow to anything resembling excess (for much of the time, it held as much cash as it had debt). Over the same span, the S&P 500 registered a compound annual return of 5.6% (counting reinvested dividends).

From a single business—the workboats that service offshore oil and gas drilling—Seacor has built a portfolio. Besides the legacy Offshore Marine Services segment, which contributed 25.1% of consolidated revenues and 52.1% of operating income in the past 12 months, the company boasts an Aviation Services division (11.5% of revenues and operating income alike) and an Inland River Services branch (7.8% of revenues and 16.5% of operating income). The Seacor Environmental Services unit, Johnny-on-the-spot in the Gulf of Mexico oil-well blowout, disclosed record results last quarter.

The reason for this diversification, Fabrikant has playfully written his shareholders, is not, "as some may believe . . . attention deficit disorder, but rather a conviction that, if opportunity knocks, we should open the door."

At Seacor, as at the old Teledyne Inc. under the leadership of the late, great Henry Singleton, opportunity takes many forms, capital allocation not least. Thus, for instance, Seacor this year paid $63 million to redeem the outstanding 7.54% notes it had issued in 1996 to finance the purchase of a pair of double-hull petroleum product and chemical tankers. Why pay such a fancy rate of interest on a loan secured by cash and ships under long-term contract? Fabrikant could see none. As of June 30, companywide debt amounted to 26.6% of total capitalization. Adjusting for cash, marketable securities and the capital reserve fund (after taxes and fees), Seacor showed less than $60 million of net debt against book equity of $1.92 billion.

The big tent of Seacor does shelter business segments that might be classified as "capital lite"—Environmental Services and Commodity Trading and Logistics, for instance—but they are the exceptions. Capital intensity is the rule. However, despite the call on corporate cash from the wear and tear of operations, the company manages to throw off sufficient free cash to permit heavy share repurchases. In 2010 alone, 1,615,900 shares were removed from the market for an aggregate $120 million, or an average of $74.26 a share.

A properly skeptical mind will be wondering if Seacor's shrinking share count has come at the expense of the upkeep on its workboats, helicopters and tankers. If such were the case, it would be no wonder that the stock changed hands at an 8% discount to June 30 book value. However, we believe, that is not the case. For one thing, the company takes a conservative approach to depreciation. It writes down the value of its workboats in 20 years and its helicopters in 12; some of its competitors choose 25 years and 15 years, respectively. For another thing, management has a demonstrated ability to sell underperforming assets at prices greater than the values at which they were carried under GAAP.

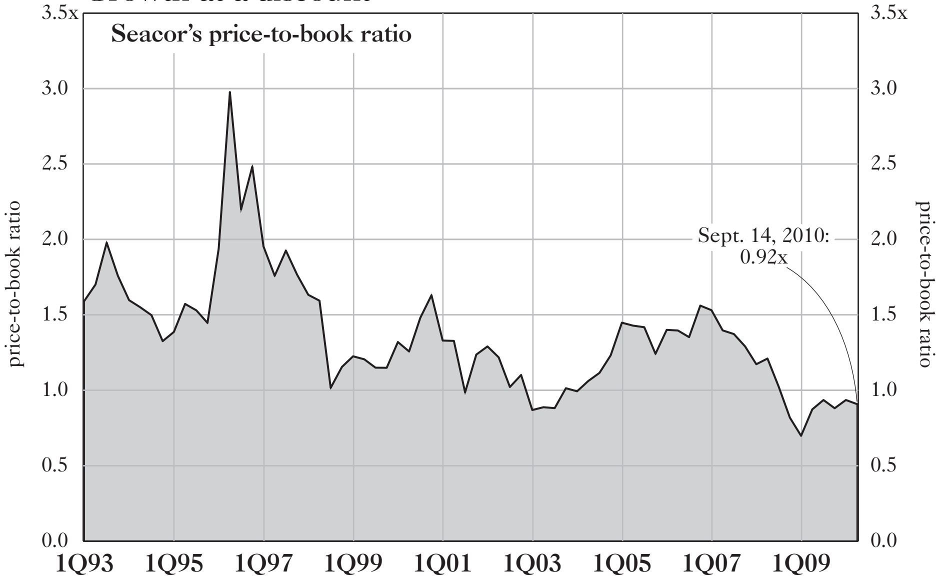
Like Teledyne under Singleton, Seacor under Fabrikant disdains the games that Wall Street plays. It holds no conference calls, vouchsafes no earnings guidance and pays no dividend. It expenses, rather than capitalizes, the costs of dry-dockings and redeployments, or "mobilizations," as they are known in the trade. Other companies defer and amortize the cost of vessel transits. In contrast, Seacor recognizes such ex-

Seacor Holdings
(in $ thousands, except per-share data)

	12 mos. to 6/30/10	2009	2008	2007
Operating revenues	$2,011,740	$1,711,338	$1,655,956	$1,359,230
Costs and expenses:				
Operating	(1,477,600)	(1,185,096)	(1,071,116)	(832,403)
Administrative and general	(170,257)	(161,998)	(174,878)	(147,317)
Depreciation and amortization	(164,005)	(160,092)	(156,426)	(154,307)
Gains on asset dispositions, net	28,987	27,675	89,153	122,572
Operating income	228,865	231,827	342,689	347,775
Earnings per share (diluted)	5.35	6.57	9.25	9.04
Shares outstanding (diluted)	22,187,114	23,388,168	24,699,181	27,266,750
Cash and cash equivalents*	$721,560	$857,807	$655,803	$1,001,721
Total assets	3,726,890	3,723,619	3,459,654	3,566,445
Long-term debt, cap. leases	688,201	755,328	903,374	904,595
Stockholders' equity	1,921,194	1,957,262	1,630,150	1,641,940
Share price	$83.13			
Market cap	1,763,876			
Price/book	0.92x			
Price/earnings	15.54			

*includes restricted cash, marketable securites, Title XI and construction reserve funds

Growth at a discount



source: The Bloomberg

pense as incurred, and it has incurred a fair amount of it over the past year. So doing, the company produces the kind of quarter-to-quarter irregularities in reported net income of which Wall Street despairs. Fabrikant knows full well how poorly this style of management plays on CNBC, but he's undeterred. "While I, personally, do not consider quarter-to-quarter variation in profits indicative of the value of our business," he wrote the stockholders a few years ago, "the nature of markets is short-term oriented."

Any newspaper reader can think of a reason or two why a business with substantial exposure to offshore oil and gas drilling should trade at a discount to book value. Then, again, such regulatory crises come and go, while there seems nothing transient in Fabrikant's ability to compound net worth in the low to mid-teens. So quirky a business is Seacor that easy comparisons are hard to find. Tidewater Inc. (TDW on the Big Board), the No. 1 offshore energy transportation enterprise, has compounded growth in its book value per share since 1992 at 60% of the rate of Seacor, yet has, until recently, traded at a higher multiple of book.

We know a long-term holder of Seacor. To characterize him as "bullish" wouldn't do justice to his nuanced frustration. It's a hard company to know, he says of the one that he does, in fact, know pretty well. And it's a hard stock to trade. Because Fabrikant operates like an investor, he acts first and elucidates second. "So far," our source goes on, "even though he's done a great job, there's a value-trap overhang. No comps, don't know what it's worth, it's languishing. The opportunity . . . is to buy it at a discount and it trades to a premium. . . , which it does over time every year. Possibly, he gets a halo effect, like Warren Buffett or Leucadia. Wake up one day and say, 'This guy is really good at what he does.' One thing he doesn't give shareholders is a reasonable time line (e.g., 'I'm going to get you a decent return in the short to medium term')."

Corporations are, in theory, immortal. So, too, are hedge funds, though a fund is only as secure as its money is patient. Fabrikant, age 65, our source continues, "is longer term than our clients, in effect, and he can be. Great store of value over a long period of time, but over the next two to three years, just don't know."

How should a stock be valued if the CEO of the company that issues it can compound book value over the course of a cycle at 15%? "Book value? Definitely," our anonymous investor concludes. "Slight premium to book? Definitely. Large premium to book? Not sure." Neither are we. But, at the prevailing 8% discount, count us bullish.

•

Ron Paul for executor

(October 1, 2010) These days, America's federally compliant, too-big-to-fail financial institutions are hard at work on their living wills. The next time disaster strikes, the authors of the Dodd-Frank reform legislation stipulate, banking behemoths must have plans at the ready to dissolve themselves, rather than have the taxpayers pay to wind them up. The Federal Deposit Insurance Corp. was pushing for such an approach to crisis management even before the 848 pages of HR 4173 landed on the nation's coffee table this summer with such a startling thud. Don't worry, Sheila Bair has told the bankers whose deposits her agency insures: It won't take more than 500 hours to throw together an acceptable submission.

But we have been thinking: If the likes of Bank of America, J.P. Morgan and Citigroup have to draw up end-of-days contingency plans, what about the central bank that lit the fuse on the bomb that nearly blew up the economy? Surely, it should have to make preparations for its own dissolution, too. Following is a short-form living will for the Federal Reserve. We submit it pro bono.

Actually, it may hearten Chairwoman Bair to know that it takes nothing like 500 hours to draft a suitable plan. Colleague Evan Lorenz was on the job for no more than 90 minutes, and he seems to have hit the highlights, starting with the identity of the Fed's executor (it's the Republican congressman from Texas).

Why would the Fed ever have to go out of business? Highly leveraged financial institutions forever wobble on the cusp of disaster, and the Federal Reserve Bank of New York, the largest of the Fed's 12 satellite banks, is leveraged 71:1. Maybe its management will zig when it ought to zag, and financial problems will overwhelm the parent.

More likely is that the Fed will encounter insurmountable political difficulties. What might Congress do if the gospel of H. Parker Willis (*Grant's*, Sept. 17) took root? Or if the people rose up to protest against the unanticipated consequences of zero-percent interest rates, quantitative easing and improvisational central planning? The Fed came into the world on a wave of Progressive Era reform. Maybe it will leave the world on a wave of modernist, free-market reform.

The Fed is vast and multitasking. It fixes the funds rate, regulates banks, administers the distribution of cash and coinage, clears checks, watches over buried gold at the New York branch, manages assets and lends (as a matter of last resort) to illiquid or even insolvent depository institutions in times of crisis. Shutting down such an enterprise in an orderly fashion will require careful planning, just as Christopher Dodd and Barney Frank were saying.

As to the funds rate, to which so much econometric research and learned discussion within the Federal Reserve is devoted, we hereby entrust it to the market. As recently as the chairmanship of Paul A. Volcker, it was the supply and demand that set the interest rate. In general, the central-planning remit of the Federal Reserve—nowhere to be found in the enabling legislation—should disappear with the institution that tries (futilely) to discharge it.

No. 2, the regulatory function. The Fed is merely duplicative or triplicative. The FDIC and the Office of the Comptroller of the Currency (not to mention the state banking commissions) do what the Fed does. If the central bank's voice vanished from the national regulatory choir, who would miss it? Pre-Fed, banks held much more equity capital than they have post-. If the cost of failure were moved squarely back to the officers, directors and shareholders, perhaps the nation could get by with fewer regulators, fewer rules and fewer bailouts. When did the taxpayers vote themselves a first- or second-loss position in the too-big-to-fail capital structure?

No. 3, the distribution of cash and loose change, and the clearing of checks. Let Brinks handle the cash and Coinstar the pennies, nickels, dimes, quarters and newfangled, base-metal, president-themed dollars. Check clearing? Maybe the Fed's employees would choose to carry on in a private setting. They could do a management buyout.

Next comes the trove of monetary gold buried underneath the New York Fed on Liberty Street in lower Manhattan. Goldline could assume the guardianship function—marketing, too. Glenn Beck and Monica Crowley would share spokesperson duties.

The Fed has, of course, been accumulating a mountainous portfolio of mortgage-backed securities, Treasurys and miscellaneous risk assets (the latter, a legacy of the bailout to save Bear Stearns). Blackrock and Pimco already manage the so-called toxic portion of the Fed's balance sheet. We bequeath the rundown of the investment-grade segment to our friends at Annaly Capital Management (NLY) and Redwood Trust (RWT).

As to the critical lender-of-last-resort function, let the Treasury do it. Having managed the Troubled Asset Relief Program (TARP), Alexander Hamilton's old department knows all too much about crisis intervention. Come to think of it, in the new, post-Fed world, maybe Treasury could forget what it learned and let insolvent financial institutions go to their just rewards. Better margins for the survivors.

You say that the foregoing is nonsense? Perhaps, but what about the pre-need funeral planning being forced on the big commercial banks? Can you imagine old man Morgan or George F. Baker meekly turning over to the government a set of directions for disassembling their good and liquid and storm-proof banks? It's a measure of how far down the road of the socialization of credit we have collectively traveled that nothing about the living-will initiative seems especially out of the ordinary. Futile? Yes, perhaps—but not extraordinary. Really, shouldn't it seem extraordinary?

•