GRANT'S

JAMES GRANT
EDITOR

Happy and Merry

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

This compilation of recent articles, our 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. 11, 2013.

Sincerely yours,

James Grant

GRANT'S

INTEREST RATE OBSERVER®

Vol. 30 Winter Break | Two Wall Street, New York, New York 10005 • www.grantspub.com | DECEMBER 28, 2012

Calm before the storm

(October 5, 2012) Dollar bills will tumble from the digital presses until the labor market gets a pulse. Only then will the very same dollars be magically caused to disappear. In this way, pledges the Bank of Bernanke, there will be no unscripted inflation and no unsightly bubbles, only a controlled, 2%-per-annum rise in the general price level, as defined. It will be as if quantitative easing, parts one, two and three, never happened.

Now begins an essay in doubt and speculation. We doubt that the Federal Reserve will recognize the moment at which to backpedal, and we speculate that the future will bear no obvious resemblance to that version of the future that the Fed today makes bold to forecast. Hold on to your hats is the executive summary of the *Grant's* credit and interest-rate forecast; details—particularly with respect to the new risks confronting investors in mortgage real estate investment trusts—to follow.

On Sept. 13, the Federal Open Market Committee pledged to purchase $40 billion of mortgage-backed securities each month until the American economy does what its government tells it to do. "Even after the economy starts to recover more quickly, even after the unemployment rate begins to move down more decisively," said the chairman in the press conference following the announcement of QE-unlimited, "we're not going to rush to begin to tighten policy. We're going to give it some time to make sure the recovery is well established."

"Well established" by the Fed's own lights—but how bright is that illumination? Let us review the evidence. "There are some straws in the wind that housing markets are cooling a bit," Chairman Bernanke told Congress on Feb. 15, 2006. "Our expectation is that the decline in activity or the slowing in activity will be moderate; that house prices will probably continue to rise but not at the same pace that they had been rising." Since February 2006, house prices have declined by 31%.

Bernanke was back before Congress on March 28, 2007. Yes, house prices had begun to weaken—they were down by 1% from the peak. "At this juncture, however," he testified, "the impact on the broader economy and financial markets of the problems in the subprime market seems likely to be contained."

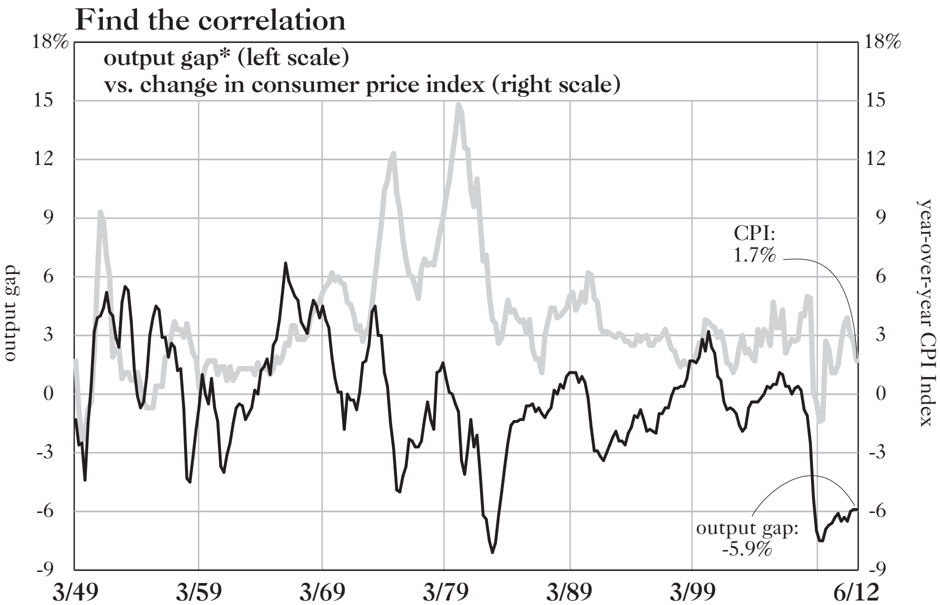
The chairman opined on the economic outlook before the Women in Housing and Finance and the Exchequer Club Joint Luncheon in Washington, D.C., on Jan. 10, 2008. "The Federal Reserve is not currently forecasting a recession," he said, one month into what turned out to be the Great Recession.

"Well, thank you, Mr. Market!"

In November 2008, Queen Elizabeth asked why economists had failed to predict the biggest cyclical event of their lives. In July 2010, the Committee on Science and Technology of the U.S. House of Representatives sought answers to the same question, particularly as it touched on the Fed's econometric models: Are they any good at all?

"The dominant macro model has for some time been the Dynamic Stochastic General Equilibrium model, or DSGE, whose name points to some of its outstanding characteristics," noted the committee in setting the scene for the inquest. "'General' indicates that the model includes all markets in the economy. 'Equilibrium' points to the assumptions that supply and demand balance out rapidly and unfailingly, and that competition reigns in markets that are undisturbed by shortages, surpluses, or involuntary unemployment. 'Dynamic' means that the model looks at the economy over time rather than at an isolated moment. 'Stochastic' corresponds to a specific type of manageable randomness built into the model that allows for unexpected events, such as oil shocks or technological changes, but assumes that the model's agents can assign a correct mathematical probability to such events, thereby making them insurable. Events to which one cannot assign a probability, and that are thus truly uncertain, are ruled out."

As for the beings who inhabit the world of DSGE, they are unlike any



*output gap is difference between potential and real GDP
source: Federal Reserve Bank of St. Louis

you might meet on the subway. Clairvoyant and immortal, they "see to the end of time and are aware of anything that might possibly ever occur, as well as the likelihood of its occurring," as the committee dryly noted. Thus, the "DSGE model excludes from the model economy almost all consequential diversity and uncertainty—characteristics that in many ways make the actual economy what it is."

What, then, did the economists have to say for themselves? "A thoughtful person," responded MIT professor emeritus and Nobel laureate Robert Solow, "faced with the thought that economic policy was being pursued on this basis, might reasonably wonder what planet he or she is on."

But the chairman expresses no such curiosity. "I would argue," said Bernanke at Princeton University, his old stomping ground, on Sept. 24, 2010, "that the recent financial crisis was more of a failure of economic engineering and economic management than of what I have called economic science." He readily admitted that the DSGE models had failed to predict the smashup. And neither "did they incorporate very easily the effects of financial instability."

But that did not mean, Bernanke continued, that the "workhorse new-Keynesian" was irrelevant or irredeemably flawed. "Economic models," said the chairman, "are useful only in the context for which they are designed. Most of the time, including during recessions, serious financial instability is not an issue. The standard models were designed for these non-crisis periods, and they have proven quite useful in that context. Notably, they were part of the intellectual framework that helped deliver low inflation and macroeconomic stability in most industrial countries during the two decades that began in the mid-1980s." In so many words, Bernanke described an analytical division of labor. He and his central banking colleagues will see to the forecasts involving low inflation and smooth sailing. Typhoon warnings, they leave to others.

Naturally, the typhoon specialists make their share of mistakes (we speak from personal experience). Many a forecast storm never happens. But at least the storm trackers' analytical framework acknowledges the possibility of turmoil, upset, temporary mass delusion and other such normal occurrences in the financial and economic life on planet Earth.

"[I]f a model doesn't include abnormal times as a special case of normal time," David C. Colander, professor of economics at Middlebury College, helpfully noted in a paper he prepared for the January 2011 meeting of the Allied Social Sciences Association, "and provides no way of distinguishing normal times from abnormal times, then the model cannot serve as your fundamental scientific model. If that is the best model one has, it is best to admit that one doesn't have a firm scientific understanding of what is going on, and to give up the pretense of fundamental science."

In New York on Sept. 19, Richard W. Fisher, president of the Federal Reserve Bank of Dallas, confessed that nobody at the Fed—neither the staff, nor the brass—really knows what's "holding back the economy"; to that extent, Fisher would seem to concur with Colander, one of the few senior monetary officials to so dissent. The personnel of the Bank of Bernanke mainly toe the chairman's line. Especially do such interest-rate suppressing and money-spinning busybodies as Charles L. Evans and William C. Dudley, presidents, respectively, of the Fed's Chicago and New York outposts, cling to the doctrine that the mandarins know best.

It makes all the difference in investing that the mandarins are just as confused as the rest of us. But adherents of the Bernanke doctrine are, in fact, disadvantaged in comparison to the average Charles Schwab customer. Practitioners whom Mr. Market has taken to school know better than to think they can predict the future. Rare is the Ph.D. with practical instruction in the field of margin calls, client redemptions or unsightly drawdowns. It is easier to believe that one can forecast coming events when one hasn't been punished for trying.

"A great deal of state-of-the-art analysis—done both inside and outside of the Fed—indicates that the severe downturn of 2008-09 was mainly the result of a large drop in aggregate demand which left the economy operating below its potential," said Evans in a Sept. 18 speech at Ann Arbor, Mich. "Research also shows that better and more accommodative policies have the power to reverse these setbacks and raise employment, output and incomes. In other words, more accommodative policy… can deliver these better outcomes without generating inflation that is significantly higher than the Fed's long-run goal of 2%."

Economic research "shows" many things, though it proves precious few. Either today's "nontraditional" monetary policy is inherently inflationary, or it's only potentially inflationary. Either a fast-rising price level (say, 4% to 5% measured year-over-year and sustained for more than just a few months) is baked in the cake of QE, or it's contingent on the return of full employment. Or, perhaps the choice is not between inflation and stability but among inflation, stability, debt deflation, depression and hyperinflation. Anyway, in between the lines of Evans's argument runs the unmistakable message: "We don't worry about inflation. Therefore, you shouldn't."

Disputing what we take to be the Fed's bedrock assumption about the relationship between inflation, on the one hand, and economic "slack," on the other, we do worry. Go ahead and test, as colleague Evan Lorenz has done, for the correlation between the year-over-year change in the CPI and the gap between potential and real GDP (as calculated by the Congressional Budget Office). You, like he, will find that since 1949 the two data series are not only not positively correlated, they are slightly negatively correlated (minus 0.03). They are statistical ships in the night.

To err is human. To persist in error is also human, if regrettable. To persist in error on the authority of "state-of-the-art" econometrics is the salient intellectual error of the stewards of the Ph.D. standard, the monetary system temporarily in place worldwide pending restoration of the true gold standard. Chairman Bernanke, an economics Ph.D. out of central casting, exhibits the weakness of his type by clinging to simplistic notions of monetary cause and effect. Thus, in attempting to predict the consequences of the new mortgage-backed-securities policy (the consequences they hoped for, not the ones they didn't), he held forth at the post-FOMC press conference last month as follows: "The program of MBS purchases should increase the downward pressure on long-term interest rates more generally, but also on mortgage rates, specifically, which should provide further support for the housing sector by encouraging home purchases and refinancing." Maybe all of that "should" happen (or shouldn't; one might let the market decide instead, which is another subject). The spread between the 30-year conforming mortgage rate and the yield on Fannie Mae-issued MBS has increased by eight basis points to 1.43% since the Fed's Sept. 13 announcement. Over the last 15 years, this spread has averaged 0.56%. Then, again, notes Lorenz, a May 21 bulletin from the San Francisco Fed predicted just that. There was, the San Francisco analysis said, a "weaker link between MBS yields and primary mortgages" owing to the consolidation of banks and the post-crisis culling of mortgage originators.

So—yes—the Fed is no monolith. And Bernanke is no Dear Monetary Leader. The Federal Open Market Committee is, indeed, a committee. Neither is Bernanke immortal, nor his term as chairman perpetual. It expires on Jan. 31, 2014, from which it follows that Bernanke is personally unable to guarantee the pledge of the FOMC to hold the Fed's policy rate at zero to one-quarter of one percent through the middle of 2015.

Seeking a second term in 2010, Bernanke found himself opposed by 30 senators, the most to say "nay" to any candidate for the Federal Reserve chairmanship since the Senate began voting on that question in 1978. Maybe, then, two hitches will suffice. But who would follow? If Obama defeats Romney, the nod might go to a candidate even more radical, monetarily uninhibited and model-struck than the former chairman of the Princeton economics department: William Dudley or Charles Evans, perhaps, or even Janet Yellen. Vice chairman of the Fed, Yellen is every bit the chairman's match in monetary open-handedness. "I am convinced," she said in June, "that scope remains for the FOMC to provide further policy accommodation either through its forward guidance or through additional balance-sheet actions." A Romney victory would shine the monetary spotlight on Glenn Hubbard, the Republican's economic advisor. Recall, however, Hubbard's head-scratching assertion in August that Bernanke is "a model technocrat" who should "get every consideration" for a third term. It's hard to tell the players without a scorecard when they pitch for the Establishment.

Mr. Market has weighed the odds of a rise in interest rates and registered his conclusion in a market not everyone has heard of. This is the market in interest-rate volatility. Instead of buying or selling shares of General Motors, or bushels of beans, or ounces of silver, the interest-rate vol participant buys and sells units in a yield-curve-weighted index of implied volatility on one-month Treasury options. Any questions?

In any case, Mr. Market would like you to know that rates are going nowhere, not now and not for the next two years. Since 1988, the interest-rate volatility bellwether known as the MOVE Index (short for the Merrill Lynch Option Volatility Estimate) has averaged 102 basis points. Today's reading is just 60.4 basis points.

This highly technical observation has down-to-earth implications for any who would seek income or manage risk or hedge a mortgage-bond portfolio. In sum and in preview (see the following article), it explains why tradable bank debt is cheap to junk bonds and why the cost of protecting a portfolio of mortgage-backed securities against rising interest rates is remarkably cheap.

What is so unusual today, Harley Bassman, managing director of convexity products at Credit Suisse, advises Lorenz, is that interest-rate volatility is quoted low in the future as well as in the here and now. Ordinarily, if today's vol is low, forward vol won't be. It will be quoted higher, more in line with the long-term average.

To judge by its deeds, if not its actual admissions, the Fed has decided that it can safely tamp down risk and volatility. If that is its mind-set, Bassman says, he emphatically disagrees with it (as do we). "Risk," he points out, "is not like matter in the sense that it cannot be destroyed, but has certain properties that are similar. If risk is compressed today, it may seek out the cracks in the system later on. Similar to the way that the Fed compressed risk in 2004, 2005, 2006, which led to extreme volatility and uncertainty, it's our view that they are presently compressing risk via explicit 'financial repression.' This can lead to greater risk down the road."

One of these fine days, we say, the Fed will lose control of what in the trade is known as the "risk-pricing process." Then the risk dammed up behind the walls of QE and ZIRP and Twist will come rushing down the valley. It's anyone's guess what form this unleashing of market forces may take. We say higher inflation and much higher interest rates—certainly, much higher interest-rate volatility. The longer the Fed keeps the market under its thumb, the greater the distortions in pricing of risk and the more furious the eventual reversion to a state of nature.

QE3 poses special risks to the investors in mortgage real estate investment trusts, a class of income-producing investment that has delivered exotically high interest income—at times, seemingly impossibly high interest income—for many a year (for a primer, see *Grant's*, April 6). By committing to buy up $40 billion a month of MBS, the Bank of Bernanke has presented the mortgage REITs with a poisoned chalice: inflated prices in the short run, inflated risk in the long run. By pushing up MBS prices, the Fed will likely flatter the REITs' third-quarter results. But the same buying is pushing down MBS yields and nudging homeowners, yet again, to refinance or prepay their outstanding balances. The bottom line: mortgage REIT dividend yields are bound to fall, if not this quarter—gains on sale will likely delay the pain—then eventually.

"Recall, please," Lorenz notes, "that borrowers pay precisely 100 cents on the dollar when they refinance, but mortgage REITs in this bull bond market often have MBS on their books at higher prices. For instance, at the end of the second quarter, Hatteras Financial and Annaly Capital marked their portfolios at 102.6% and 103.2%, respectively, of face value. A new refinancing wave would cost them each the premium over par.

"If MBS yields don't increase," Lorenz continues, "mortgage REITs eventually will have to cut dividends. It's a mathematical certainty. American Capital Agency Corp. (AGNC) illustrates the point. At the end of the second quarter, AGNC's assets yielded 2.81% and its liabilities cost 1.19%. Management used $7.60 in debt for every dollar of equity. What spread might AGNC be able to earn on its portfolio? Multiply the yield on the assets, 2.81%, times 8.6, that is, one unit of equity plus the aforementioned 7.6 units of debt. The answer is 24.17%. Now, to calculate the cost of funding those assets, subtract 7.6 units of debt times the aforementioned 1.19%. The result is 9.04%.

"Net yield, therefore, comes to 15.1%—that is, net yield as a percentage of equity before other operating expenses. But all this was before QE3. Between June 30 and Oct. 1, the yield on the current coupon 30-year Fannie MBS fell to 2% from 2.57%. If the yield on AGNC's portfolio fell to 2% from the 2.81% prevailing at the end of the second quarter, and if leverage and the cost of funds remained the same, net interest as a percent of equity would have fallen to 8.2%. AGNC trades at 119% of second-quarter book value (though book value is likely to increase thanks to the Fed-induced rally in MBS prices), and, based on analyst expectations, is priced for an indicated dividend yield of 14.3%. But in the current yield environment, you can't get from here to there."

Will mortgage REIT dividend yields fall? "Absolutely," Annaly CIO and COO Wellington J. Denahan-Norris emphatically replies to Lorenz's question. "I think anybody would be foolish not to recognize that returns across all sectors are going to decline. You can't squeeze the spread out of the market and expect everything to stay as it was. I think people will try to compensate with leverage, but I think it may be foolish to do so."

Because, as Bassman notes, risk can be redirected or repackaged or repressed but can't be eliminated, the risk of running a levered mortgage portfolio is on the upswing. "There's been a lot of extension risk in the mortgage industry leading up to QE3," Hatteras CEO Michael R. Hough says. (Extension risk refers to the lengthening of the maturity of a mortgage-backed security as a result of a slowdown in prepayments.) "At this point in the game going forward, there's going to be more than we've probably ever seen and that is risk that needs to be respected. I think that risk managers such as Hatteras and other asset/liability managers have to be willing to be respectful of that and use caution when running these businesses. It's hard to foresee rates at much lower than we are at right now. With that comes more risk. So I think caution from here going forward is more appropriate than it's ever been.

"There's different ways to manage risk on a levered balance sheet," Hough continues, "the most effective way is through leverage. I think we'll just have to see. There is no great hurry but the amount of money they are pumping into the system brings new risks into the world, especially the world of interest rates that we have to be aware of. As you know, Hatteras has always been very defensive in our interest-rate risk management, which is why we stayed in ARMs [adjustable rate mortgages] and why we've done it the way we've always done it. Now we see additional risk in the market."

A complicating factor for investors seeking to hedge risk is the upcoming requirement to post collateral for swaps and derivatives trades (*Grant's*, Sept. 21). When rates begin their next ascent, prepayment rates will plummet. Managers who locked up collateral to hedge their portfolios might find themselves trapped in a longer duration, low-yielding portfolio while, at the same time, taking negative marks on their portfolios. "[T]here will come a time when extension risk and lack of prepayments are the bigger issue for the market as rates are rising and you need those cash flows to rebalance your position," Denahan-Norris observes.

And herein lies the rub. While the mortgage REIT value proposition has suddenly worsened, so has every other income-generating value proposition. Relatively speaking—and there is no other language in investing—the likes of Annaly, Hatteras and American Capital Agency still beat most of the income-producing alternatives.

"I don't think anyone has seen this set of circumstances lining up," says Denahan-Norris, "and it's difficult to know what the ultimate outcome will be and how long it will take to get there. For us—we've been well telegraphed in this—our stance is to be conservative. What we are producing in a sub-2% 10-year [Treasury] world I think is still very attractive relative to a bigger, broader menu of options for investors."

•

Monetary corporate welfare

(October 5, 2012) After the Lehman Brothers bankruptcy in 2008, the Bush administration, on behalf of the mute American taxpayer, opened the federal vaults to Wall Street. Sheila Bair, in her new memoir of that crisis season ("Bull by the Horns"), recounts the decision to push TARP funds into the not necessarily needy arms of the CEOs of nine of the country's largest banks and broker-dealers. "Yes," relates the former chairman of the FDIC, "it had come to that: the government of the United States, the bastion of free enterprise and private markets, was going to forcibly inject $125 billion of taxpayer money into those behemoths to make sure they all stayed afloat."

General Electric was not among the nine. But it presently took its place at the government's all-you-could-eat steam table. When it received $139 billion in FDIC debt guarantees and placed $16 billion in commercial paper with the Federal Reserve, this bluest blood of American blue chips—the last of the original Dow stocks still in the Dow—was rated triple-A. Not many federal supplicants have ever cut a more awkward appearance with a begging bowl.

This was four years ago—four long years ago, to be sure. On Monday, the very same GE—no longer rated triple-A, rather a slice or two beneath it, but still a deep-blue blue chip—showed its face in the credit markets to refinance $5 billion of 5% notes due next Feb. 1. In the high-cotton days of 2007, the company had placed an issue of 5¼% notes due December 2017. If proof were needed that nobody holds a grudge for long on Wall Street, at least not against an institution, the 5¼s were quoted Tuesday at a price to yield 1.54%.

As for the new notes, $7 billion worth, they were briskly bid for at yields of 0.85% for three years, 2.72% for 10 years and 4.16% for 30 years. The Fed's tiny interest rates now subsidize a company that, except for its doting Uncle Sam, might not be around today in just its current form to borrow so much as a dime. (Vis-à-vis GE, the government was not entirely doting; on Aug. 4, 2009, the company, or rather its shareholders, paid $50 million to settle SEC charges that it had cooked the books and manipulated earnings during the great bull market of the late 1990s and early 2000s; see *Grant's*, Sept. 18, 2009). Among the underwriters of the new GE issue was none other than Citigroup, about whose serial bailouts and inexpert CEO Bair's memoir is particularly scathing.

"Citi had essentially bought into all the gimmicks to generate short-term profits," she recites: "poorly underwritten loans, high-risk securities investments, and short-term unstable liquidity. It desperately needed an experienced, traditional commercial banker to right the ship. [Vikram] Pandit had no experience in commercial banking and wouldn't have known how to underwrite a loan if his life depended on it. But he was the guy [Robert Rubin] wanted and the N.Y. Fed and the OCC acquiesced, so he got the job."

"Proceeds" from the GE offering "will be used to repay all or a portion of the company's $5 billion of 5% notes due Feb. 1, 2013," S&P reported. "Any remaining proceeds will be used for general corporate purposes."

Artificial, ultra-low rates harm many. But they do benefit some.

•

The thing itself

(September 21, 2012) Rare is the goldbug who owns the object of his or her desire. GLD, the gold exchange-traded fund, is gold at one remove. The shares of Newmont Mining or any precious-metals mutual fund are gold at an even greater remove. Dealing in the barbarous relic itself has never been easy. But it is getting easier.

Enter—or, rather, for the readers of *Grant's*, re-enter—Gold Bullion International, a fledgling business devoted to making the buying and selling of physical gold as easy as transacting in stocks and bonds (*Grant's*, April 22, 2011). Not every commercial venture can claim the chairman of the Federal Reserve Board as its not-so-silent partner, but GBI is one of them. A progress report follows.

Let us say that you are a Merrill Lynch customer. Long ago you accustomed yourself to Merrill's electronic order entry system. To buy or sell stocks, you type in the ticker, quantity and price limit. For bonds, you enter the coupon and maturity date. And now, thanks to GBI, the same basic protocol does duty for gold. For instance, the code letters "GGZOZ" instruct the Thundering Herd to buy you an ounce of bullion to be stored in Zurich. "GGNOK" is the ticker for a kilogram of gold stored in New York. Those data encoded, the gold investor specifies volume and price. Evidence of the transaction, or transactions, duly appear on your statement. (GBI also provides the technology for the SmartMetals Platform, a creation of a consortium of precious-metals newsletters operating under the banner of the Hard Assets Alliance.)

Make no mistake, this is a 21st-century technique miles ahead of the methods of the old coin shops. A customer's gold is insured and audited. Buying or selling, one receives the best price submitted by 14 participating dealers. For card-carrying members of the 1%, fees are comparable to GLD's. As to storage, you can elect a Brinks or Via Mat vault or the comforting proximity of your own cabbage patch. GBI vaults are situated in Salt Lake City, London and Melbourne, as well as Zurich and New York.

In America, gold is all but unknown in institutional investment portfolios—Warren Buffett doesn't approve of it, and, besides, it produces no income. But there is a bullish case, of course, and GBI would be happy to show the establishment the light. Indeed, the personnel at GBI are themselves establishmentarians. Steven Feldman, the CEO, and Eric S. Schwartz, chairman, are former partners of Goldman Sachs. The board includes a retired four-star general, Wesley K. Clark; a former SEC chairman, Arthur Levitt; and a former "Most Influential Person under 40" (in the opinion of the editors of *Fortune* magazine), Sally Krawcheck. The board isn't entirely pure of monetary and investment heresy. But the one director who has risked his reputation in gold, John Hathaway, portfolio manager of the Tocqueville Gold Fund, is—at least—a Harvard man.

Exceptional in so many ways, America is unusual in its appetite for gold, attest Feldman and GBI's president, Savneet Singh. That appetite is bird-like. Self-directed individuals do buy some, but professional investors mainly stand aside. On a scale of one to 10, with 10 being *Grant's*-level bullishness, China and India are 10s, institutional America a one—actually, "not even a one," Singh says, but a figure closer to the federal funds target rate. Singapore is a gold-buying comer, Feldman adds, "really the Zurich of Asia."

"I went on a trip to Asia in February or March," Singh says, "and I probably had 30 meetings, and I think out of 30 meetings, 28 said, 'Yes, we'd like to use your product.' Whereas, in the U.S., if I had 30 meetings, you'd get a couple that would say, 'Yes,' and 25 that would say, 'We'll think about it.'" In Asia, Singh summed up, he sells. In America, he teaches.

Feldman insisted they're no calamity-howlers. Sitting down with a prospect, "We say, 'Look, this is unarguably a safe-haven asset, and we can provide it to you at similar fees as GLD with better liquidity, because if the New York Stock Exchange goes down, you can still trade with us because we're off-exchange. And you're insured, and you're audited, and you can take delivery, and you don't have to worry about credit or counterparty risk. Why wouldn't you do it?'

"We have a lot of respect for GLD," Feldman goes on, "it was there first and really exposed gold to the retail investor. We just don't equate first with only or best. GLD is best for people trying to trade more frequently, who just want the performance of gold. They don't believe in the need for the physical or tangible asset; that's OK. We don't know how many Lehmans and Peregrines and MF Globals people need to make more of them act on their desire to be more exposed to physical assets, which don't have these risks. I know how cognitive economics works. I'm a professional investor in lots of different businesses. People always assume it's never going to happen to them, until it's them.

"We're not alarmists. We don't sell end-of-the-world paradigms by any stretch of the imagination. We definitely lead in with gold as part of a well-diversified portfolio, and an even more important part of that diversification given what's going on today…. We say, 'It's important always, but it's more important now because of negative real interest rates on the one hand, which are eroding purchasing power, and all this government intervention on the other, which makes shocks and tail events that much more likely and unpredictable. In these conditions, you want gold in your portfolio.'"

And in your vault.

•

What the chairman didn't mention

(September 7, 2012) An undramatic reading of 19 pages of double-spaced text lifted stocks, bonds, commodities and non-dollar monetary assets on the Friday before Labor Day. In a few short hours, the price of gold rallied by more than the $35 per ounce at which it was officially valued between the mid-1930s and the early 1970s. The text, "Monetary Policy since the Onset of the Crisis," and the mind of the man who recited it, the chairman of the Federal Reserve Board, are the subjects at hand.

"Self-parody and self-plagiarism, neither intentional, are the bugbears of the aging author," wrote Whitney Balliett, the late, great jazz critic at *The New Yorker*. The readers of *Grant's* don't need to be told. The aging Ben Bernanke has been saying one thing, your aging editor another for a decade. We persist because he persists, and because monetary ideas have consequences. If we're right about the chairman's message, danger and opportunity are staring the holders of dollar-denominated assets right in the face. We write to try to sort out risk and reward.

It's old news, though worth repeating for emphasis, that the Jackson Hole, Wyo., address broadly hinted at a further radical monetary stroke. "The stagnation of the labor market in particular is a grave concern," warned Bernanke, "not only because of the enormous suffering and waste of human talent it entails, but also because persistently high levels of unemployment will wreak structural damage on our economy that could last for many years. Over the past five years, the Federal Reserve has acted to support economic growth and foster job creation, and it is important to achieve further progress, particularly in the labor market. Taking due account of the uncertainties and limits of its policy tools, the Federal Reserve will provide additional policy accommodation as needed to promote a stronger economic recovery and sustained improvement in labor market conditions in a context of price stability."

For a trade, the market seized on the phrase, "will provide additional policy accommodation as needed." For an investment, it may profitably consider the more important and revealing words, "[t]aking due account of the uncertainties and limits of its policy tools." It makes all the difference that the chairman does not, in fact, take due account of the "uncertainties and limits" of his "policy tools." He may pay them lip service, as he did in his speech. But he does not really weigh the costs and benefits of doing what no other American central banker has done before. With Bernanke, as with Adm. David Farragut, it's "[d]amn the torpedoes, full speed ahead," though Farragut's aggression, unlike Bernanke's, got quick and quantifiable results.

Shining through the chairman's text is the conviction that economic problems are susceptible to a monetary solution. For every monetary-policy action, Bernanke all but said out loud, there is a predictable reaction. That is, for policy A, you may bet your boots on outcome B. For ourselves, we have come to believe—the past five years have decided us on the question—that while policy A may deliver outcome B, it may alternatively serve up outcomes J or Q or Z—or, not inconceivably, some other result too strange to be classified under a known English letter. Especially are surprises in store for the makers of "non-traditional" policy—and for the millions on the receiving end of those inventions.

Bernanke makes no bones that he is improvising. "Large scale asset purchases," a.k.a. QE, and the "maturity extension program," a.k.a. Operation Twist, are, if not absolutely novel in concept, then unprecedented in scale. "[W]e were guided by some general principles and some insightful academic work but—with the important exception of the Japanese case—limited historical experience," the chairman admitted. "As a result, central bankers in the United States, and those in other advanced economies facing similar problems, have been in the process of learning by doing."

All of us learn by doing. To learn how to ride a bicycle, we pedal. But money has been circulating for millennia, and there is a voluminous monetary record. It is there to be read. Did the chairman or his staff consult the wisdom of the ages before deciding to muscle around the yield curve, manipulate asset values, materialize dollars by the hundreds of billions and, in general, to short-circuit the price mechanism? Not on the evidence of the four-and-a-half-page bibliography appended to the Bernanke text. To judge by this reading list, the chairman consulted no authority published before 1965. He cites relatively few sources published before the onset of the 2007 financial cave-in. His favorite authors are his employees at the Federal Reserve Board.

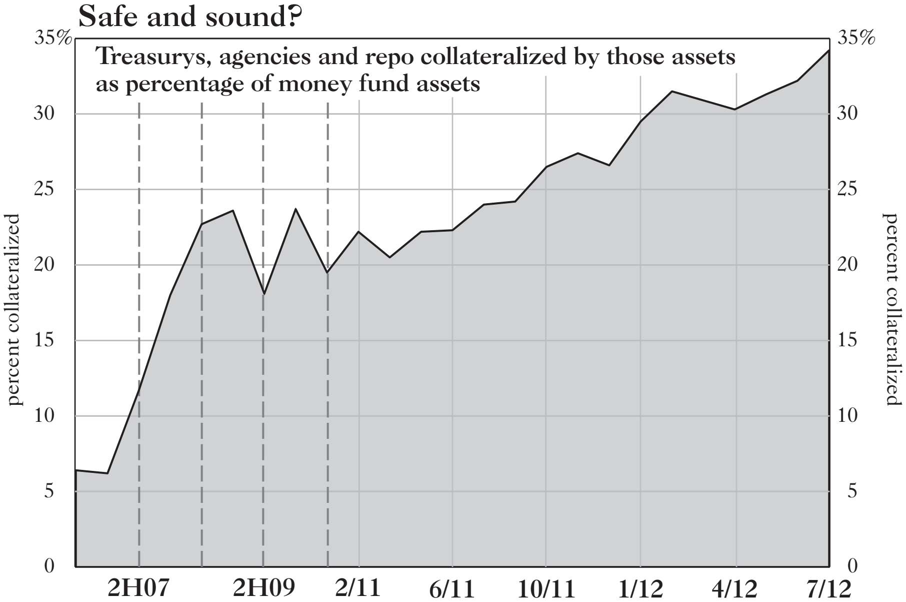
Perhaps not surprisingly, Bernanke and his authorities are in broad agreement on the post-2007 policy record of U.S. monetary policy. It is swell, they conclude. "After nearly four years of experience with large-scale asset purchases," said Bernanke, "a substantial body of empirical work on their effects has emerged. Generally, this research finds that the Federal Reserve's large-scale purchases have significantly lowered long-term Treasury yields."

And not only Treasury yields, he goes on. QE has tamped down mortgage rates and corporate bond yields and firmed up stock prices: "it is probably not a coincidence that the sustained recovery in U.S. equity prices began in March 2009, shortly after the [Federal Open Market Committee's] decision to greatly expand securities purchases. This effect is potentially important because stock values affect both consumption and investment decisions."

So you didn't build that, Mr. Market. The Federal Reserve got the rally rolling—and much to the advantage of the macroeconomic situation, too, Bernanke judged. Granted, the chairman told his audience, there's no telling how the economy might have fared in the absence of these improvised measures. But, "if we are willing to take as a working assumption that the effects of easier financial conditions on the economy are similar to those observed historically, then econometric models can be used to estimate the effects of [QE] on the economy." The Fed's own models rate the Fed's monetary policy a winner, the chairman again noted: "as of 2012, the first two rounds of LSAPs may have raised the level of output by almost 3% and increased private payroll employment by more then two million jobs, relative to what otherwise would have occurred."

Striking the pose of a disinterested scholar, the chairman next sought to persuade his listeners that he had considered the risks, not just the rewards, of monetary experimentation. He mentioned four potential pitfalls, of which the first was the risk that the Fed's interventions might impair the "functioning" of the securities markets. Second was the chance that QE might frighten the uninitiated into doubting the Fed's ability to normalize policy without seeding a new inflation. Third was the risk to "financial stability" presented by the temptation to reach for yield in these times of pygmy interest rates. Fourth was the possibility that the Fed might suffer a mark-to-market loss "should interest rates rise to an unexpected extent" (a slightly disingenuous point given the 2011 accounting change that shifts the burden of absorbing financial losses away from the Fed and onto the Treasury; on this

Safe and sound?



source: Fitch Ratings

little-reported innovation, so handy for an activist and leveraged central bank, the chairman was silent). All these risks the chairman discounted.

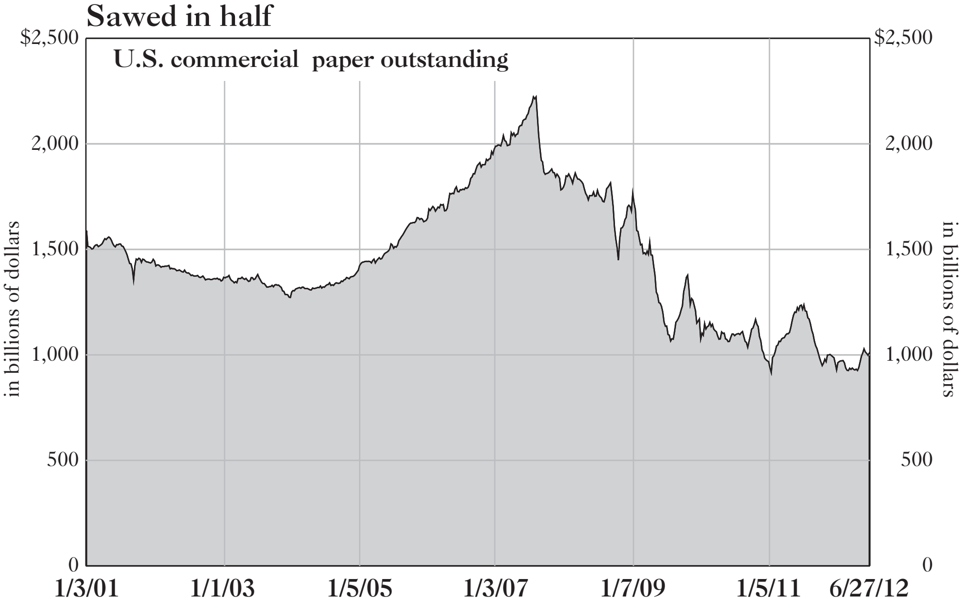
Omissions from the Bernanke checklist of unintended consequences and undesirable side effects, though they received no press, deserve the attention of every investor. He said nothing about the distortions wrought by the so-called zero-percent interest rate policy on the allocation of capital or on the analysis of investment value. Neither did he acknowledge how the whisking away of interest income has punished savers and nudged them into unsuitable risk taking. Though quick to claim credit for the decline in mortgage rates or the rise in stock prices, Bernanke was characteristically mute on the Fed's contribution to resurgent prices of commodities and farmland. We commend to the chairman the cover story in the August 18 issue of *The Spectator*, published in London. "Hunger strikes," says the headline: "Rising food prices will mean more revolutions."

With a lot more time and a little more candor, Bernanke could have held forth for hours in this vein. The crisis-era money market alone could have afforded him all the material he needed. Zero-percent interest rates and blanket FDIC guarantees of bank deposits have reconfigured what used to be a market in short-dated IOUs of the private sector. Today's money market is increasingly a market of short-dated IOUs of the public sector.

Before the rains came in 2007, money market mutual funds earmarked just 6.2% of their assets for Treasury securities, agency obligations and repurchase obligations collateralized by the same. As of last report in July, according to an Aug. 29 bulletin from Fitch Ratings, such holdings weighed in at 34.2% of money-fund assets. Midway in 2007, $2.2 trillion of commercial paper—unsecured corporate promissory notes—was outstanding. Less than half of that amount is issued today. As Bernanke did not get around to saying in Jackson Hole, zero-percent interest rates obviate the value of credit analysis. When a given claim yields nothing, the prudent investor will roll Treasury bills or—functionally the same thing—lay up deposits at a too-big-to-fail bank.

Zero-percent interest rates may impart no credit information, but that doesn't mean they're inexpressive. "Be afraid, Mr. or Ms. Investor, because the government is afraid," is the subliminal message. It's a suggestion that the post-crisis regulatory regime powerfully reinforces. The 2010 amendments to Rule 2a-7 of the Investment Company Act of 1940, for instance, slap tough new liquidity tests on money market mutual funds. They require that 10% of the assets of a taxable fund be held in cash, U.S. Treasurys or securities that convert to cash the next business day. And they require that 30% of the assets of a taxable fund be placed in securities that mature within 60 days or that convert to cash within five business days. Pre-crisis, the money-fund managements decided such matters for themselves.

Sawed in half



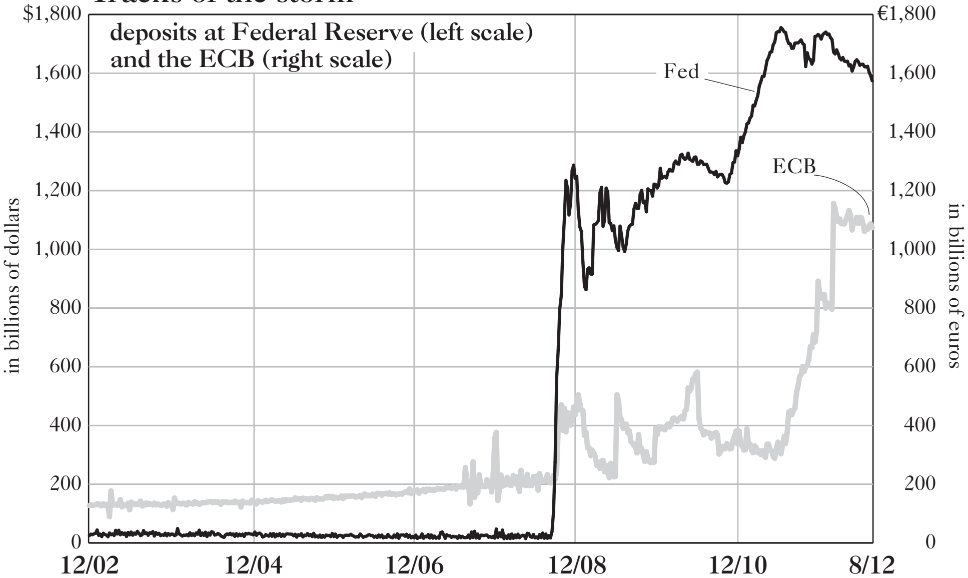
source: Federal Reserve

Post-crisis, the government has its knives out, and the new rules push the funds into the least remunerative spots on the nearly barren money market credit and liquidity curves. Thus, the smaller funds face starvation, the biggest funds malnutrition. Nancy Prior, president of Fidelity's Money Market Group, the nation's largest, told readers of the June issue of *Money Fund Intelligence* that "we monitor every single dollar, every hour," and that there are no fewer than 80 Fidelity money market credit analysts on the case, some of whom "can hop on a plane or a train and be in Germany, Brussels or France in an hour." It is, however, travel, overhead expense and man-hours expended in the service of delivering a 0.01% return, pretax, to the investors in Fidelity Cash Reserves.

That ultra-low interest rates tend to beget even lower—and more dysfunctional—rates is another side effect of zero-percent rate policy that the chairman didn't talk about. He could have cited the example of the European Central Bank, which in July shaved the rate it pays on bank deposits to zero percent from 25 basis points. By this adjustment, Mario Draghi, president of the ECB, presumably expected to drive money out of his vaults and into the receding European economy. But the funds have stayed put while other yields have actually turned negative. It stands to reason that repurchase rates on the highest quality collateral would be quoted at less than zero if that collateral itself—short-dated notes issued by the governments of Germany, Denmark and Switzerland, for instance—yields zero percent or less. As optimism has a life of its own, so does pessimism, and the central bankers are having a hard time cheering up the glum and broken-spirited survivors of the panic of 2008. They'll have an even harder time of it after the €1.1 trillion European money-market industry starts passing along negative interest rates to its hapless investors, as FT.com is reporting the funds are preparing to do.

In June 2011, Jamie Dimon put a question to Bernanke at a banking conference in Atlanta. The CEO of JPMorgan Chase & Co. asked the chairman if the regulatory and market response to the financial crisis might not be hurting recovery rather than helping it. Regula-

Tracks of the storm



sources: Federal Reserve, European Central Bank

tors are tougher, credit committees are tougher and examiners are tougher, Dimon observed. "Has anyone bothered to study the cumulative effect of all these things?" he posed.

Bernanke replied that he, for one, was gratified by how thoroughly the government had scoured the system. As to Dimon's question, he answered that no one had attempted to study the cumulative effect of so much rule and policy making and that, in truth, "it's just too complicated, we don't really have the quantitative tools to do that." And the chairman had a most revealing afterthought. He had a "pet peeve," he said, about people insisting that "the single cause of the crisis was 'x.' There was not a single cause of the crisis," Bernanke went on. "There were many, many different causes, and they interacted in a way that was in many ways unpredictable, and led to the disaster that we experienced."

So, after all, the chairman was prepared to concede that outcomes are unpredictable, that financial systems are complex and that policies implemented for one purpose can wind up serving another. Yet the very same Bernanke, speaking at Jackson Hole, talked up the new federal crisis-prevention bureau, the Financial Stability Oversight Council, as if it had powers of divination never before available to the federal bureaucracy. "We have seen little evidence thus far of unsafe buildups of risk or leverage," he said, "but we will continue both our careful oversight and the implementation of financial regulatory reforms aimed at reducing systemic risk."

Market economies excel at identifying and repricing error. Regimented economies, in contrast, are ill suited to making mid-course corrections, as the only thing the Dear Leader despises more than error is the messenger who tells him about it.

America's Dear Leaders are the functionaries who are busily substituting bureaucracy for the price mechanism. Nowadays, when things go pear-shaped, Chairman Bernanke is front and center with broad hints to print enough money or suppress enough prices or inflate enough assets to make us forget our troubles. Don't worry that QE or Twist or ZIRP will end in inflationary tears, Bernanke counseled at Jackson Hole: "The FOMC has spent considerable effort planning and testing our exit strategy and will act decisively to execute it at the appropriate time."

But, of course, Mr. Market doesn't hand out wristwatches. It isn't the Fed's efforts or good intentions one doubts, but its judgment. As for our judgment, as fallible as anyone's, we expect that our drugged bond markets will give no helpful signal that the central banks of the world have overcranked the printing presses. The radical monetary experiments of 2012 will strike posterity as the most obvious setup to a virulent inflation there ever was, except that our monetary mandarins had no clue it was happening.

In 1921, O.M.W. Sprague, author of "History of Crises under the National Banking System," contributed an essay on the Federal Reserve, then just seven years young, to *The American Economic Review*. In it, Sprague, a Harvard professor, warned against the temptation to print one's way out of cyclical trouble. The Fed had hugely expanded the nation's money and credit to help the Treasury finance America's participation in World War I. There had been a rip-roaring inflation. And now came the time to undo the inflationary damage. What, if anything, could the new central bank do to smooth the process of adjustment?

"If we insist upon using such power as a means of temporary relief and stimulation," wrote Sprague, "ultimate disaster is the certain consequence. Past experience shows that it is dangerous for governments to issue paper money. There is a constant temptation to overissue when confronted by real or imaginary emergencies. The same danger arises in the case of the [R]eserve system—that public opinion and perhaps legislative action will compel the employment of its resources in a vain endeavor to cure evils which are mainly due to credit already granted in excess."

Now comes Chairman Bernanke, a Harvard man himself, doing exactly what Sprague warned against, and with the support of the 21st-century economics establishment. *Grant's* is betting on a new inflation with a flight of investable funds from the assets that are today deemed safe (notably, sovereign debt) to assets deemed infra dig or permanently impaired (for instance, precious metals and equities). Anyway, "nontraditional" central banking is a short sale.

•

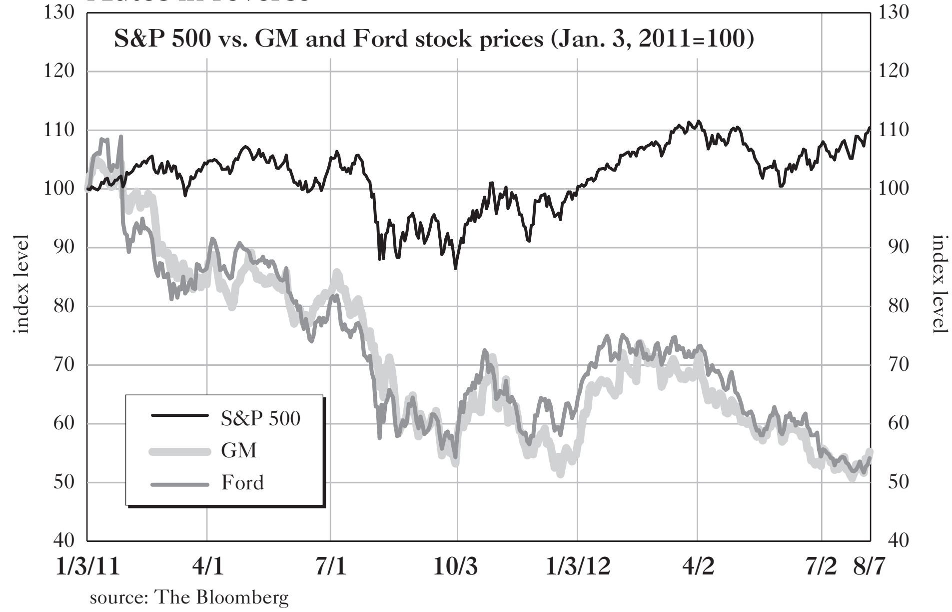
Bullish on the one with the hair

(August 10, 2012) "Charlie," General Motors CEO Rick Wagoner addressed the talk-show host Charlie Rose on Aug. 18, 2008, the year of the 100th anniversary of GM's founding, "I think the future's very bright." Let us only say that the former GM boss was early. Now unfolding is the bullish case for the company they call—but may not long continue to call—Government Motors.

How the mighty GM, the corporate edifice built by Durant and Raskob, Sloan and Wilson, became a supplicant to Timothy Geithner's Treasury Department, side by side with the U.S. Postal Service, Fannie Mae and Freddie Mac, is a sad story oft told. Lackluster products, unfunded pension liabilities, immense losses and reduced liquidity mortally weakened the maker of Corvettes, Cadillacs and Rivieras—and of Corvairs and Volts and subprime mortgages, too. In 2009, General Motors fell like a half-rotten tree.

Six weeks after a $50 billion, taxpayer-financed tow into the Chapter 11 garage, however, there emerged the reorganized GM. You could hardly tell it was the same company. Compared to the pre-bankruptcy lemon, "new" GM boasted 40% fewer dealers and $79 billion less debt. It gained a few things, too: wage concessions from the United Auto Workers Union and billions of dollars worth of tax-loss carryforwards. On Nov. 18, 2010, came the IPO, priced at $33 a share. On Jan. 6, 2011, came the intraday high of $39.48 a share. From that day til this, the stock has been sawed in half.

Autos in reverse



source: The Bloomberg

The bill of particulars against GM makes familiar reading. Thus, the company derives 17.8% of its revenue from Europe and 19% of its net income from China. It ranks fifth in sales but 20th in profits on the 2012 *Fortune* 500 roster. It's losing domestic market share, and rock-bottom interest rates have inflated the value of its pension obligations. The executive suite seems to have a revolving door. A June review of GM's new minivan, the Spin, on The Truth about Cars Web site, ran out under the headline, "Dog of an engine devours any desire to buy." European inventories are high and rising. And if all that weren't bad enough, the company has an itchy minority owner in the U.S. government. Of the 1.57 billion GM shares outstanding, the Treasury owns—and will sooner or later sell—500 million.

Mr. Market is as fed up as anyone. At five or so times the 2013 earnings estimate, and at 1.8 times enterprise value to projected EBITDA (i.e., earnings before interest, taxes, depreciation and amortization), the stock is seemingly valued for every contingency except good news.

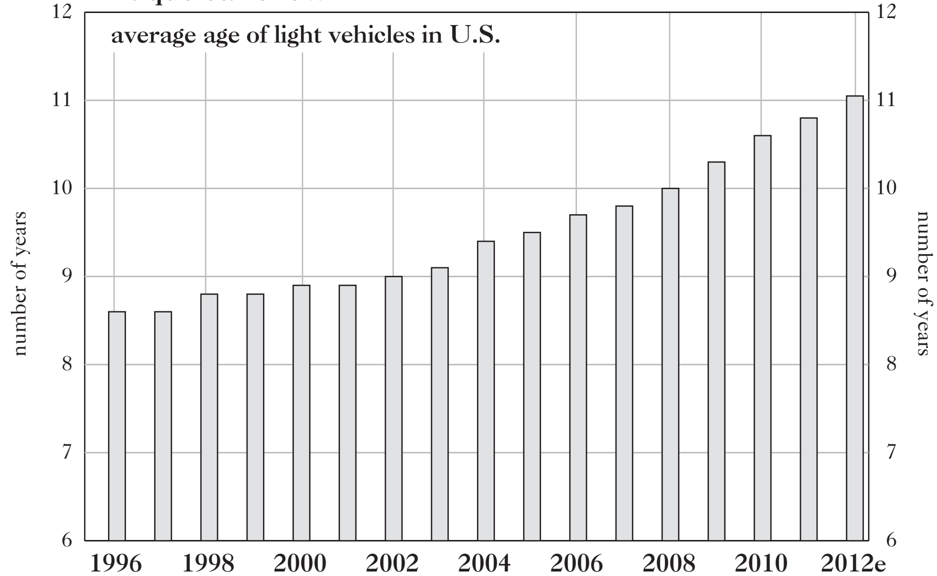
Then, again, the worldwide auto business is running on the valuation rims. Archrival Ford, the North American auto company that didn't go running to the government in 2009 (except for a $5.9 billion Department of Energy "green" retooling credit), is quoted at 6.15 times the 2013 estimate, and at a 2.5 multiple of EV to 2013 EBITDA. Like GM, Ford has its problems in Europe. Unlike GM, however, Ford is thriving in North America. It has regained its investment-grade debt rating and reinstated the dividend it stopped paying in 2006.

Volkswagen, the world's No. 2 automaker by production, is quoted at 5.3 times the 2013 estimate and at a dividend yield of 2.23%. Perhaps investors worry about the German company's home continent, or about VW's proclivity for discounting—you can buy a 2012 Golf today for €12,990, compared to the original list price of almost €17,000—or about the risk that management might not seamlessly execute its plan to replace many different engineering and production platforms with a single platform, a project known as the "modular transverse toolkit." Or, perhaps, the market is casting a wary eye toward China, where VW sold 28% of its vehicles in the first half of 2012 (do not be concerned about the People's Republic was the message from the Volkswagen second-quarter conference call). Or—yet another possibility—the problem is governance. No ordinary public company, "Volkswagen is basically now an Austrian family-owned company that coincidentally happens to be traded on the exchange. . . . [I]t's not exactly a company run for shareholders." So said Ferdinand Dudenhöffer, director of the Center for Automotive Research at the University of Duisberg-Essen, in March on the occasion of the nomination of the wife of Chairman Ferdinand Piech to VW's board of directors. Top owner of Volkswagen shares, with 50.7% of the outstanding, is Porsche Automobil Holding SE, i.e., the Porsche-Piech family. Second-largest holder is the German state of Lower Saxony, home to VW headquarters as well as to six VW plants and many of its half-million employees. By dint of that investment, Lower Saxony holds veto power over major VW corporate decisions. It seems a fair guess that the politicians won't vote their stock as, say, Carl Icahn would.

The question, therefore, is not whether the automakers are driving on economic black ice, but whether the market has adequately, or more than adequately, compensated for that known risk. In the case of GM, we think it has more than compensated. Much has gone wrong with the company that Peter Drucker extolled more than 60 years ago in his ground-breaking management study, "The Concept of the Corporation." And much will continue to go wrong, no doubt. Yet the post-Wagoner management team is effecting improvements, and the post-2008-09 auto market seems ripe for recovery—timing uncertain, we hasten to add.

In the palmy days of 2007, Americans bought 16 million cars and trucks, a number that seemed a reliable floor but hardly a ceiling. However, we Americans bought not with cash but with credit, credit that was supported by bloated real estate collateral. Cars busted along with houses, the annual vehicle selling rate plunging to 10.4 million units in 2009. It recovered to 11.6 million units in 2010 and 12.8 million in 2011. And the rate may reach 14 million or even 14.5 million units in 2012. As for the prospects of ever returning to the mountain top of 16 million units, they are, in fact, surprisingly good. One doesn't have to assume growth in vehicles per household to get there, only continued population growth of a little under 1% per year. At that rate the automakers would return to the good old days of 16 million sales as soon as 2015.

Antique car show



sources: WardsAuto.com, R.L. Polk & Co., JPMorgan

The buying drought of recent years has put some fancy figures on American odometers. At 11 years, the average car and truck on American highways in 2011 was the oldest on record. Considered in tandem with the reciprocally low rate of scrappage, the aging of the American fleet will presumably set consumers to hankering after that new-car smell. And more and more can afford it. To purchase and finance an average-priced new car required 23.2 weeks of median family income as of the first quarter, according to the Comerica Auto Affordability Index. That was within a whisker of the all-time most affordable period, the third quarter of 2009, and compares with the post-1978 average of 26.9 weeks of income.

There is another silver lining to GM's difficulties. As an IRS-conferred consolation prize for the eight consecutive quarters of red ink logged between 2007 and 2009, the company, as of year-end 2011, owned $47.2 billion of deferred tax assets before valuation allowances. While analysts may quibble about the correct discount rate to apply to the net operating loss, they will concur that GM is unlikely to be paying taxes to the U.S. government for another six years at least.

At the June 12 annual meeting, Daniel F. Akerson, chairman and CEO, pledged to "make GM great again," and in the same breath mentioned the disparity between sales and earnings that is so glaringly evident in the *Fortune* 500 rankings. As it is, GM is producing operating margins of not quite 6%—last year, it delivered sales of $150.3 billion, adjusted EBIT of $8.3 billion and $4.58 of diluted earnings per share. So far in 2012, it has generated sales of $75.4 billion, adjusted EBIT of $4.3 billion and diluted earnings per share of $1.49. And how might management make the leap from federal dependence to capitalist greatness?

"Our journey starts with our products," the CEO answered, "and I am pleased to report that we are now in the early days of one of the biggest global product offensives in our history. The impact of new vehicles will be especially profound in the United States, where about 70% of our nameplates will be new or freshened over the course of 2012 and 2013." Examples include the Chevrolet Spark mini-car, the Buick Verano Turbo and the new Cadillac XTS and ATS luxury sedans.

As to whether GM's new product

"offensive" is so markedly bigger and better than anyone else's, colleague David Peligal remarks: "It's all about the timing. GM will have an edge in so-called refreshes in both 2013 and 2014. By the looks of a chart in a July 18 JPMorgan research report, GM's North American product-refresh rate is larger by about 25% in 2013 and 8% in 2014. A bigger difference, though, is that, while Ford will be revamping low-margin vehicles, GM will be focusing on high-margin ones. Full-size trucks are where the money is—they may produce earnings before interest and taxes of $10,000 each, or about 10 times the EBIT of a small car. GM will sell more of these trucks and at a better price point.

"Something else about new products," Peligal proceeds, "they command better prices than showroom-worn merchandise. Over the five-year life of the typical automobile or truck product line, or—as they say in Detroit—'platform,' years one and two deliver better prices than years four and five. In the second place, new offerings make for better market share. In large pickup trucks, GM's top profit driver (a sweet spot for the Big Three generally, as pickup-truck drivers as a class tend to buy American and only American), it has ceded domestic market share to Ford and Chrysler because the competition's offerings are newer and shinier than GM's. In the seven months through July 31, GM claimed around 36% of the American truck market, down from 40% just three years ago. Why buy this year's Chevrolet Silverado or GMC Sierra when, in 2013, GM management will pull back the curtains on the new K2XX platform?

"Putting it all together," Peligal winds up, "if we're right that the industry will grow in North America, and that GM can regain a measure of market share, you could see the company's top line in North America climb to $100 billion from $90 billion. If management can find its way to a 10% operating margin, roughly 220 basis points more than it is posting today, therein lies $2 billion to $3 billion of improvement in operating profit, equal to $1.11 per share to $1.67 per fully diluted share—none of which will be taxed for a long, long time."

Well and good, a bear might interject, but GM has three hurdles to clear. The first is miniature interest rates, and a paradoxically high hurdle it is. With pension assets of $109 billion and pension obligations of $134 billion, the company faces an unfunded liability of $25 billion (as of year-end 2011 measured under GAAP conventions). As part of a drive to close the deficit, management is offering lump-sum payments to some retirees in lieu of a promised stream of pension income. Also in the cause of pension "de-risking," GM is paying Prudential Financial no less than $4 billion to take $26 billion of liabilities off its hands.

However, as fast as the front office can de-risk, the Federal Open Market Committee re-risks. Low and lower interest rates require a pension obligor to come up with more and more capital. One thousand dollars will generate $60 a year of interest income at a 6% interest rate, but it takes $2,000 to generate the same income at a 3% interest rate.

While it's a stretch to call GM a back-door play on rising interest rates, there is some element of truth in that notion, at least in the matter of pension obligations. According to the 2011 10-K report, a 25 basis-point rise in the discount rate, considered in isolation, would reduce the U.S. pension benefit obligation by $2.66 billion. Given that the unfunded portion of the company's pension obligation comes to $24 billion (or will when the Prudential deal closes), the return of the 10-year Treasury note to the alpine heights of 3% would shrink that obligation to $8 billion ($2.66 billion times six increments of 25 basis points comes to $16 billion).

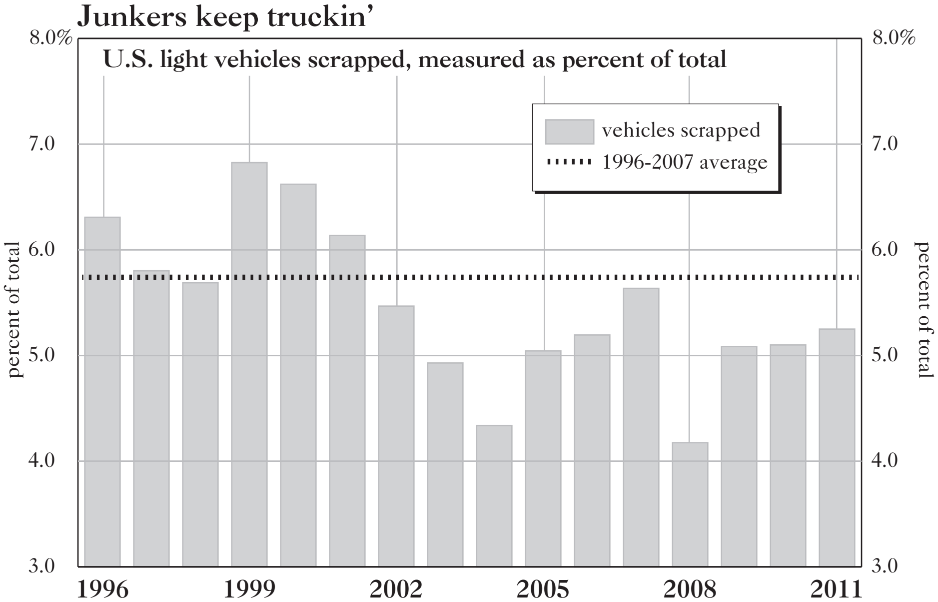
Incidentally, GM's pension fund last year deftly boosted its bond allocation to 66% of the portfolio from 41% in 2010. By so doing, it returned 11.1% in a year when the S&P 500, with dividends reinvested, was up 2.1%. Kudos to the portfolio managers. And double kudos if they manage the trick of getting out of bonds, when the time comes, as profitably as they got into them.

On balance, in the article of interest rates, we would venture (borrowing from former GM chief Charles Wilson) that what is good for the country is good for General Motors and vice versa. Normalized interest rates, borne of rising prosperity, would be good for the country and GM alike. As it is, a qualified customer can finance a 2013 Cadillac XTS luxury sedan at 3.9% APR for 60 months. Gently rising rates (underscore "gently," please) might be just what the doctor ordered.

Hurdle No. 2 is the state of the vehicle business in what Google is wont to call the "Rest of the World." Last year, GM produced nine million cars and trucks in 30 countries. Some 72% of those sales took place outside North America. And of these sales in the hinterlands, 43.4% occurred in the so-called emerging markets, e.g., Brazil, India, Russia, China, etc. Europe accounted for 1.7 million sales, or not quite 27% of the non-North American total.

Of Europe, the best that can be said—and it is no small thing—is that

Junkers keep truckin'



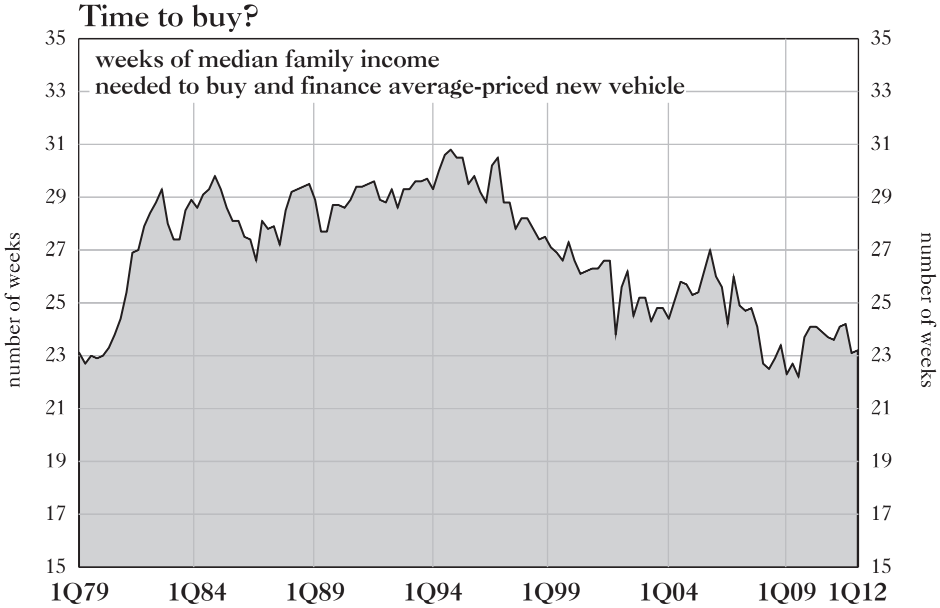
sources: WardsAuto.com, R.L. Polk & Co.

everybody hates it. In 2010, General Motors Europe, a.k.a. GME, produced an operating loss of $1.95 billion on revenues of $24.1 billion. In 2011, the European division turned in an operating loss of $747 million on $26.8 billion of revenue. And in the first six months of 2012, GME delivered an operating loss of $617 million on $11.4 billion in revenue. Just when the European auto business might be put to rights is anyone's guess. Ford is on record as saying not for five years. Sergio Marchionne, CEO of Fiat, calls the old Continent "a bloodbath of pricing and it's a bloodbath on margins." According to a July 25 research bulletin from Deutsche Bank, European automakers are operating at only 72% of capacity, compared to 98% in the United States. Is it so hard to imagine the statesmen and stateswomen of Europe coming together to forge a constructive solution to the raging sovereign debt crisis? Or to imagine the European Central Bank lending a hand with a generous outpouring of new paper euros, thereby igniting the mother of all relief rallies and a few quarters, at least, of commercial recovery? Well, yes, it is very hard to imagine these things, especially the first, but we owe it to ourselves to try. There is probably no more hardened consensus of opinion than that Europe is a lost cause.

As for China, GM operates through joint ventures of which it owns just shy of 50%. To date, what's been good for China has been very good for GM, its JVs commanding a 14% share of the market, tops in the People's Republic. And China has remitted a steadily rising stream of net income back to Detroit: $753 million in 2009, $1.31 billion in 2010, $1.46 billion in 2011 and $719 million in the first half of 2012. This publication, as bearish as it is on China, regards GM's exposure to the People's Republic as perhaps the greatest risk the market has not adequately discounted. South America, the company's main emerging-markets under achiever, sends home a pittance of earnings, or a small net loss, on revenues in the neighborhood of $16 billion. Even a 3% EBIT margin would produce a swing in net income to $500 million from minus $100 million. To effect the desired results, GM has been working to reduce break-even costs (via lower headcounts and more advantageous union contracts) as well as by introducing such new products as the Chevrolet Cobalt and the Chevrolet Cruze.

Hurdle No. 3 is the overhang of U.S. Treasury-owned shares, 500 million, or just over 30% of the total. Many ask: Why get into GM before the government gets out? To get out whole, Secretary Geithner would need a price of $53 a share. With the 2012 presidential election looming, let us say it is unlikely that the Obama administration will choose to call attention to its investment in GM with a pre-November sale. Yet, one day the feds will sell—Mitt Romney is on record as pledging an early liquidation, should the former private-equity titan win the White House. As for the former community organizer, he, too, would likely entertain a motion to sell if he won a second term.

Time to buy?



source: Comerica Economic Insights

Then, who would buy? Not likely the oft-burned retail investor. Neither the casual institutional investor who, after a cruise through the relevant Bloomberg pages, judges GM to be a low-margin business making hard-to-differentiate products—really, our imagined portfolio manager will reason, GM might as well be a call on the macro economy. A much more likely candidate for the purchase of the people's stock is GM itself.

Certainly, the company has the resources, Europe or no Europe, and China or no China. As of June 30, the balance sheet showed $32.6 billion of cash and marketable securities against $5.1 billion of debt.

"If you think about their current cash position and what is really required for them to run the business," Peligal says, "GM would probably say that $25 billion of liquidity would suffice. The company already has a $5 billion revolving line of credit. Ford, with a smaller balance sheet, has a $10 billion revolver. But say that GM is willing to borrow no more than $5 billion. Any way you slice it, the company sits with just under $35 billion of available liquidity (after giving effect to the $4 billion earmarked for Prudential Financial). At $20 a share, the Treasury's stake is worth $10 billion—and GM has that $10 billion to spend. And what better use of cash than to buy in shares valued at five times the estimate and at less than two times EV to EBITDA?"

So how do we value Government Motors? Acknowledging that the exercise is an art, not a science, let us proceed. Enterprise value, as you know, is defined as equity market cap plus debt at par minus cash, though there are wrinkles.

Peligal presents the *Grant's* estimates. "Let's use 1.8 billion fully diluted shares, taking into consideration the conversion of the convertible preferred, which makes a fully diluted equity market cap of $36.45 billion. To which we add: $5.1 billion of debt, $910 million of minority interest, $7.2 billion of other post-employment benefits (OPEB), $6.9 billion in preferred and $24 billion for unfunded pension liabilities. Which adds up to $80.56 billion.

"From which," Peligal proceeds, "we subtract $16 billion in net operating loss, $4 billion for GM Financial (valued at book), $10 billion for the Chinese joint ventures (to the earnings of which we assign a P/E multiple of 6.3 times), $28.6 billion of cash and marketable securities (anticipating the year-end payment to the Pru) and $300 million for the corporate stake in Ally Financial. What you're left with is an enterprise value of $21.66 billion. We assume that 'core,' or nonfinancial GM, can produce $12 billion in EBITDA. Dividing $21.66 billion by $12 billion, we find that an investor can buy GM at 1.81 times EBITDA, compared to the 3.5 times EV-to-EBITDA multiple at which the likes of Magna International, Delphi and Tenneco change hands."

Do we hear the objection that, only a few months back, this once-and-future American jewel was valued at the supposedly incredible, never-to-be see-again bargain multiple of two times EBITDA? Cheap stocks do get cheaper. However, given the strength of the company's post-bankruptcy financial position, we judge a permanent impairment of capital unlikely. More likely, we believe, is the risk of nothing much happening for a very long time.

As for something—anything—going right, who knows? Last month, three Chevrolet models—the subcompact Sonic, the compact Volt and the Avalanche pickup—earned the "best in segment" award from J.D. Power and Associates, the most of any brand (seven other brands snagged two awards). On the higher end, the first compact Cadillac in 25 years, the ATS, won huzzas from Aaron Bragman, industry analyst for IHS Automotive: "Driving wise, I think it's extremely comparable [to the BMW 3 Series]…. It feels very German to me in terms of the way it drives." Quoth Mike Colias of *Automotive News* on Monday, "In many ways, GM is in better shape than it has been in decades."

"I prefer it partly because of the hair," an investor tells Peligal when asked why he likes GM more than the safer, more flourishing Ford. GM does, indeed, have a full head of hair, i.e., of troubles, risks and contingencies. But let the record show that the company has survived moments far hairier.

"The automobile market had nearly vanished and with it our income," writes Alfred P. Sloan Jr. in "My Years with General Motors," concerning one such patch of rough road. "Most of our plants and those of the industry were shut down. . . . We were loaded with high-priced inventory and commitments at the old inflated price level. We were short of cash. We had a confused product line. There was a lack of control, and of any means of control in operations and finance, and a lack of adequate information about anything. In short, there was just about as much crisis, inside and outside, as you could wish for if you liked that sort of thing."

This was the crisis of the depression of 1920-21, a slump that, for GM, was worse by far than the Great Depression of the early 1930s. It was in 1920 that William C. Durant, the company's founder, ran up an unpayable margin debt trying vainly to prop up the sinking GM share price. To the rescue rode E.I. du Pont de Nemours & Co. and J.P. Morgan & Co.—and out on the Detroit pavement went Durant. But GM and Durant's creditors were saved.

In relating this story of decline and fall and triumphal redemption, Sloan recalls how difficult it would have been to try to compete with Henry Ford in the low-price end of the automobile market: "No conceivable amount of capital short of the United States Treasury could have sustained the losses required to take volume away from him at his own game," as Sloan put it.

Writing in the glory years of the early 1960s, Sloan could not have dreamt that the day would come when GM would indeed have to call on the Treasury. Yet, though that evil day has come, it will surely go. Before very long, Government Motors, like the depression of 1920-21, will be a chapter in the history books.

•

Human progress at a market multiple

(July 27, 2012) We live in a technological golden age but in a monetary and fiscal dark age. While physicists discover the so-called God particle, governments print and borrow by the trillions. Science and technology may hurtle forward, but money and banking race backward.

Now under way is an attempt to resolve the investment tension between technological progress and financial retrogression. Google Inc. will stand in for progress, the short-dated government security of your choice for progress-in-reverse. In preview, *Grant's* is all for progress.

Crowding into sovereign debt yielding less than nothing, investors give wide berth to equities returning—or, rather, to be exact, undertaking to return—something more than nothing. For supposed security of principal, no current yield seems too low. But for a call on human progress, no earnings yield seems adequately high.

Safety is in a bubble, this publication continues to believe. Reciprocally, progress—capitalized progress—is in a bear market. At the end of last week, the two-year obligations of the governments of Austria, Denmark, Finland, Germany, the Netherlands and Switzerland each yielded less than nothing. Google traded at a market multiple, more or less—less after adjusting for surplus cash. We are not saying, let alone insisting, that ostensible safety can't get dearer or progress cheaper. Our point is rather that progress, at current prices, seems a better and safer bet for the long haul than claims on sovereign governments denominated in the very currencies that those governments are actively working to depreciate.

From time to time, your editor tries to imagine Benjamin Franklin brought back to life. "Dr. Franklin," someone would say, handing the pioneering electrical theorist a smartphone, "the entire store of human knowledge is yours to command on this small mobile device—no charge for the search." The inventor of the lightning rod would surely be flabbergasted. How could he not be? Larry Page, Google's CEO, can hardly stop raving about the leaps and bounds of digital progress—or could, before he lost his voice—and Page was born in 1973.

We line up with Page and the imagined Franklin. Glass half-full people from way back, we stand in awe of a cash-spinning company that, among other things, holds the keys to the driverless car and the digital contact lens (for the record, your editor owns GOOG and uses the technology, including—though only rarely while in the office—YouTube). "Google is not a conventional company. We do not intend to become one." Those ringing sentences, the opening lines of the 2004

Just another company?

source: The Bloomberg

Founders' IPO Letter, set a tone that early carried GOOG aloft. As recently as 2007, the shares commanded a P/E multiple more than twice that of the S&P 500—37 vs. 16, by the respective forward estimates. Better still from the value-seeker's perspective is today's valuation: 14.3 times the estimate, following slightly better-than-expected second-quarter earnings, compared to the S&P's 13 times forward multiple. Adjust for Google's immense cash hoard, however, and the forward P/E drops to just over 12.8 times. Apple, another mighty engine of digital progress, trades cheaper (on Tuesday, it reported much worse-than-expected fiscal third-quarter earnings).

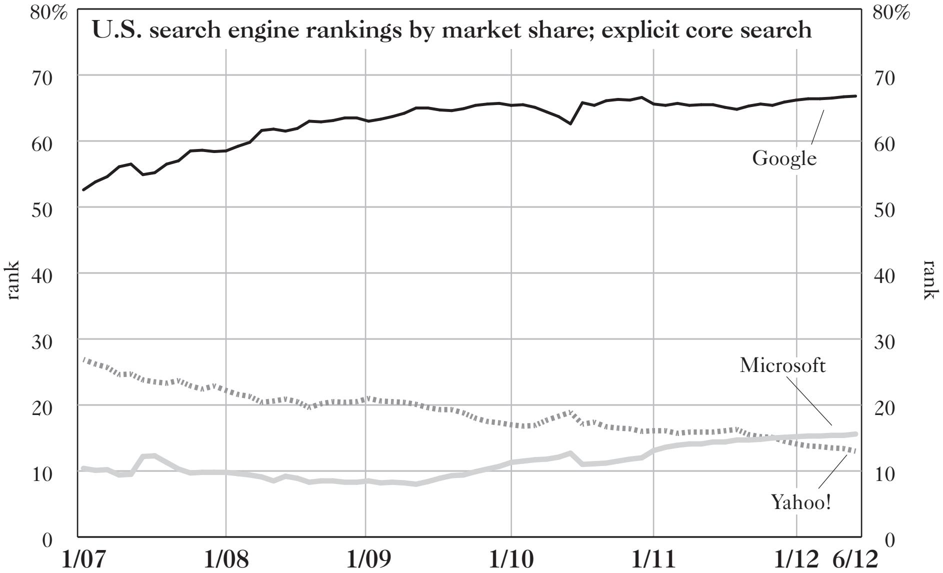
Why does Google, for all its growth and brainpower, command a mere market multiple? A skeptic can cite many possible reasons, starting with the valuation of the S&P itself. Maybe it's too high. Maybe, considering Spain and China, Stockton, Calif., and the fiscal cliff, Libor and Dodd-Frank, Obama and Romney, Google is, in fact, properly valued; it's the rest of the market that should, and will, adjust to the downside.

Then there are Google's innumerable warts, a skeptic might observe. "For starters," colleague Charley Grant notes, "for all of the company's marvelous engineering feats, Google earns 96% of its revenue (2011 total, $37.9 billion; $22.9 billion in 2012 so far) from advertising. Advertising, of course, is a cyclical business. As the Internet-connected world transitions away from the personal computer to tablets and mobile devices, ad revenues fall. Claire Cain Miller, writing in last Friday's *New York Times*, neatly summed up the predicament: 'People have long described the price difference between print and Web ads as moving from analog dollars to digital dimes. Cellphone ads could be described as trading those dimes for mobile pennies.' The cost per click for an ad you see on a cellphone is 53% cheaper than the cost per click of an ad on a personal computer, according to the Rimm-Kaufman Group. Google expects that mobile ads will generate higher revenues over time, but time will tell."

Under the heading of warts, one could also mention management's exasperating vagueness about where, exactly, the money comes from. The front office will say only that 45.6% is sourced from the United States, 10.7% from the U.K. and 43.6% from that dark region known as "rest of the world." Nor is management much more forthcoming about the status of its 39-year-old CEO—Page has "lost his voice" is the full medical report—or about the deeper meaning of the looming two-for-one stock split by which holders will receive a new Class C share for every Class A share. Voting control is vested in the Class B shares, which are largely held by founders Page and Sergey Brin, and by the executive chairman, Eric Schmidt. The decision to issue the C shares—which have no voting rights and will cement control with the ruling troika—is one the *Financial Times* termed "unusual" in its news columns, "depressing" on its editorial page.

Google's very success constitutes another kind of flaw, since it overstimulates the social envy glands. Antitrust authorities on three continents, at least, have their knives out for the worldwide leader in search and digital advertising.

Look no further



source: comScore

Then there's Google's astounding cash pile—$44.2 billion, even following the recent acquisition of Motorola Mobility for the round sum of $12.5 billion. Will the Google oligarchy consent to return even small change to the owners? It appears that Page et al. will not, but will rather continue acquiring new businesses at the customary rate of a company a week. "More than half the purchase price of Google's 79 acquisitions in 2011 was allocated to goodwill," Grant observes, "rather than to the intangible assets themselves. Such a ratio is high enough to set you wondering whether the company is spending wisely—it will be interesting to see how much goodwill is assigned to the acquisition of the lavishly unprofitable Motorola unit."

Then, too, a skeptic may reasonably wonder, as Google's technology has laid low the analog competition, might Google itself not one day fall victim to a new, new thing not of its devising? Or might Google's single-minded search for the next world-shaking innovation—it spent $5.2 billion on R&D in 2011—prove a distracting and costly hunt for a technological will-o'-the wisp? Prowl around on the tech blogs and you'll read complaints that Google is delivering fuzzier, less relevant search results. (If so, the data don't reflect it, as Google's share of American searches inched up to 66.8% in June from 66.2% in January, and from 52.6% in January 2007, according to comScore.)

All these doubts and more figure in Google's valuation, which is neither better nor worse than the kind of company that innovates a little and grows a little but holds out no claim—as Page and Brin have done since Google's inception—of getting filthy rich while transforming human life. "We have always tried to concentrate on the long term," wrote Page this year, "and to place bets on technology we believe will have a significant impact over time. It's hard to imagine now, but when we started Google most people thought search was a solved problem and that there was no money to be made apart from some banner advertising. We felt the exact opposite: that search quality was very poor, and that awesome user experiences would clearly make money."

And making money is what Google does do. It has returned no less than 16.6% on common equity in any year since its going-public year of 2004; last year's ROE was 18.7%, reflecting free cash flow of $11.1 billion. (Apple, valued at 12.8 times the fiscal 2012 estimate before Tuesday's blowup, returned 41.7% on equity in 2011). Though the second-quarter balance sheet has not yet been unveiled, the first period's EBIT coverage ratio, 169.5:1, is a figure out of the Balance Sheet Hall of Fame (Apple is debt-free).

It almost goes without saying that if there were an Innovation Hall of Fame, Google would long ago have been an inductee, along with rivals Apple, Amazon and Microsoft. Judges might have waved Google through solely on the strength of its timely acquisition and masterful nurturing of the Android operating system. Acquired in 2005 for an undisclosed sum, Android, at last report, powered 56.1% of the world's smartphones, compared to a 22.9% share for the Apple IOS, according to Gartner Inc. Among the newest Android features is one that automatically (or, in the spirit of Franklin's ghost, miraculously) delivers workaday information at the moment one needs it, e.g., commuting time, flight updates, driving instructions, weather, the choicest nearby bistro. This feature, Google Now, was a mere footnote in the company's enumeration of second-quarter achievements, but it brings to mind the fact that even Google's near hits and near misses—never mind its consequential successes—engage the lives of millions. Thus, Google+, hailed by management as "the social spine that is starting to connect everything across Google" but regarded outside Google as a bit of a dud, is a miss that has nonetheless garnered a quarter-billion users.

As for Motorola Mobility, which registered an operating loss of $233 million during the few short weeks in the second quarter in which Google owned it, the company said it was buying patents, "which will enable us to better protect Android from anti-competitive threats from Microsoft, Apple and other companies." The Motorola acquisition is said to have delivered 17,000 patents, as well as 7,500 more under Patent Office review, not to mention 20,300 employees, which brings the number of full-time employees—"Googlers," as the front office calls them—to 54,600.

To hear management tell it, the answer to the Google capital allocation question is as simple as the progression, "70%, 20%, 10%." That is, to quote Page, "70% of our resources [go] to search and advertising. We debate where we should classify our apps (Gmail, Docs, etc.) products, but they currently fall into the 20% of resources we devote to related businesses. We use the remaining 10% of our resources on areas that are farther afield but have huge potential, such as Android. We strongly believe allocating modest resources to new areas is crucial to innovate."

When fretting about Motorola or the next leg down in Europe and China, an investor might spare a thought for You-

Tube, for which Google in 2006 paid what seemed the very full price of $1.65 billion. That investment is overturning the video news and entertainment business. "I think it was in 2007. . .when newspapers frequently said YouTube is groping for an effective business model," Nikesh Arora, Google's chief business officer, reminded dialers-in on the second-quarter earnings call last week. "I think we can declare that we found our model. YouTube now unites the world through video, from the human rights channel launched this quarter to a Pew study confirming YouTube as a major global news platform, and, for the first time, YouTube will be powering NBC's live streaming of the Olympics in the U.S., while also live-streaming the games in London to 64 territories around the world. Daily account sign-ups have doubled year over year, and users are uploading over 72 hours of video every minute. This quarter, we released a new YouTube app for Android, helping users find videos and follow channels from a mobile or tablet device. We believe YouTube is now a proven winner for the whole video ecosystem."

"Who would have thought in 1998 that anyone could get for free a high-resolution picture of their house from above, and even from the street?" Page and Brin asked in their 2009 Founders' Letter. Who indeed? We ourselves, having been floored by the fax machine, are still trying to grasp the fact that one can talk into a Google-equipped smartphone in English and be heard in, say, German (convenient for future conversations with the Bundesbank about the restoration of the Deutschemark).

"Physics of the Future," a new book by Michio Kaku, professor of theoretical physics at the City University of New York, is catnip for the Google fan. Self-driving autos and Internet-connected eyewear will be commercial realities by 2030, the author predicts, and he quotes, among other authorities, a member of the Google X team, Babik A. Parviz, a University of Washington professor of electrical engineering. Right off the bat, Internet-connected eyewear will help diabetics regulate their glucose levels, Parviz tells the author. But by and by, the vistas will be limitless. "Parviz envisions the day," Kaku writes, "when we will be able to download any movie, song, Web site or piece of information off the Internet into our contact lens. . . . From the comfort of the beach, we will be able to teleconference to the office by blinking."

Good for some people, a skeptic will retort. Besides, the future usually looks rosy. The outlook was glorious in 1913 and 1929. Nasdaq couldn't miss in March 2000, and Chester Carlson was quite possibly counting his money on the day he invented xerography in 1938 (the Xerox 914 model copier didn't appear until 1959). As for the auto-auto, artists' renderings of that anticipated marvel were published in magazines like the *Saturday Evening Post* in the 1950s. The *Post* is long gone, but we 21st-century motorists are still sitting behind the wheel and not facing backward on a swiveling bucket seat playing a board game with our happy children, as the magazine pictured life in the not-so-distant future.

"What we do not say," analyst Grant concludes, "is that such long shots as the driverless car and the digitized lens are sure to pay off, only that they might and that the cost of laying them a bullish bet is reasonably low." At the *Grant's* Conference in New York early in 2011, Michael Harkins, a Google bull and a Bloomberg customer, invited the audience to imagine the day when "Larry Page gets out of bed and says, 'I wonder if there's anything more in the financial space for us to do?' About two hours later," said Harkins, "the Bloomberg will look like a Quotron did 20 years ago." That a thrust at Wall Street is not beyond the realm of imagining is implicit in the Google approach to innovation. Quoth Page and Brin in 2009: "Finding important technological areas where progress is currently slow, but could be made fast, is what Google is all about."

Every investment requires a modicum of trust. An investment in Google requires an almost devout belief in the judgment of the founders. "New investors will fully share in Google's long-term economic future but will have little ability to influence its strategic decisions through their voting rights," Page served fair notice in 2004. And he added for emphasis, "By investing in Google, you are placing an unusual long-term bet on the team, especially Sergey and me."

Oligarchs and despots and the self-perpetuating executives of American mutual savings banks have also asked for unimpeded freedom of action, of course. Page and Brin, at least, are proven miracle workers, not just aspiring ones. Still, Google's owners will sink or swim with the technological and capital-allocation decisions of the people who serve at their own discretion and who work not because they have to but because they want to. Nor will there be any help for the shareholders of Google from the market in corporate control. No Bill Ackman is going to show up demanding a special dividend

Google Inc.
(in $ millions)

	first half of 2012	2011	2010	2009	2008	2007	CAGR (2007-2011)
Revenue	$22,859	$37,905	$29,321	$23,651	$21,796	$16,594	18.0%
EBIT	6,592	11,742	10,381	8,312	6,632	5,084	18.2
Operating margin	28.8%	31.0%	35.4%	35.2%	30.4%	30.6%	—
Net income	$5,675	$9,737	$8,505	$6,520	$4,227	$4,204	18.3
Return on equity	17.5%	18.7%	20.6%	20.3%	16.6%	21.2%	—
Research and development expense	$3,026	$5,162	$3,762	$2,843	$2,793	$2,120	19.5
Cash from operations	7,946	14,565	11,081	9,315	7,853	5,775	20.3
Free cash flow	6,565	11,127	7,063	8,506	5,494	3,373	27.0
Current assets	53,857	52,758	41,562	29,167	20,178	17,289	25.0
Current liabilities	14,028	8,913	9,996	2,747	2,302	2,036	34.4
Shareholders' equity	64,721	58,145	46,241	36,004	28,239	22,690	20.7
Employees	54,604	32,467	24,400	19,835	20,222	16,805	14.1

source: The Bloomberg, company reports

financed by the halving of the Google X R&D budget—or else. Given the Google ownership structure, Page and Brin may remain entrenched for as long as they choose. The essential Google value proposition takes the simple form that the resident geniuses will discover the next great idea, that they will render it commercially valuable, foiling the antitrust police in the process, and that they themselves will somehow avoid being devoured by the very revolution they have helped to uncork.

Investment in government securities at prevailing low yields requires a different kind of trust. The bond bulls repose their faith in paper money and the stewards thereof, in Murphy's Law and in the long life of the interest-rate downtrend that began 31 years ago. However, with yields near zero, there is no margin of safety. Everything must go wrong for the bond trade to go right. A spark of hope in hiring, a flash of economic growth or an intimation of political compromise in debt and deficit reduction—in Europe, a commitment by the ECB to more QE—could send government securities prices reeling.

Last week in Europe, €4.2 billion of German two-year notes—"schatz" bonds to the initiates—were hammered down at a yield to maturity of minus six basis points. The news, however, is not that Germany is regarded as a safe haven but that so many other dubious European sovereigns have come to share the same magnetic power for timid money.

"Although German government bonds have been one of the favored investments of investors seeking shelter from the eurozone crisis," the *Financial Times* reports, "continually pushing yields across the curve to record lows this year, the low or negligible yields on offer have spurred investors into Europe's 'soft core' in recent weeks. . . . Even Belgium, one of the continent's more indebted countries, which has often been paralysed by political wrangling, can now borrow for about 0.25% for two years. Belgium and the European Stability Facility, one of the eurozone rescue funds, sold shorter-term bills at a negative yield for the first time on Tuesday."

The investment choice is hardly limited to Belgian bills vs. Google common, or Larry Page vs. Ben Bernanke, or Sergey Brin vs. Mario Draghi, or technological success vs. monetary and fiscal failure. However, if those are the choices, we'll take Google. The central bankers we leave to others.

•

Just in case

(July 13, 2012) "We are all losing our shirts today. You know, we're making no money. It's all in the red."

The speaker was Rex Tillerson, chief executive officer of Exxon Mobil, the date was June 27 and the price of natural gas on the day he spoke was around $2.50 per thousand cubic feet. "What I can tell you," Tillerson informed an audience at the Council on Foreign Relations in New York, "is the cost to supply is not $2.50."

Now begins an exploration of the speculative possibilities of higher energy prices. We introduce a pair of orphaned equities and revisit an issue of cast-off bonds. And we preface the analysis with what may or may not be a bullish straw in the wind. Late last month, Petronas, Malaysia's state-owned oil and gas company, paid a 77% premium to buy Calgary-based Progress Energy Resources. It wasn't lost on Petronas that LNG (liquefied natural gas) has commanded six times the price in Asia that ordinary gas does in North America. E&P investors, hard-hit this year, briefly dried their tears on receipt of the news of the C$5.5 billion transaction.

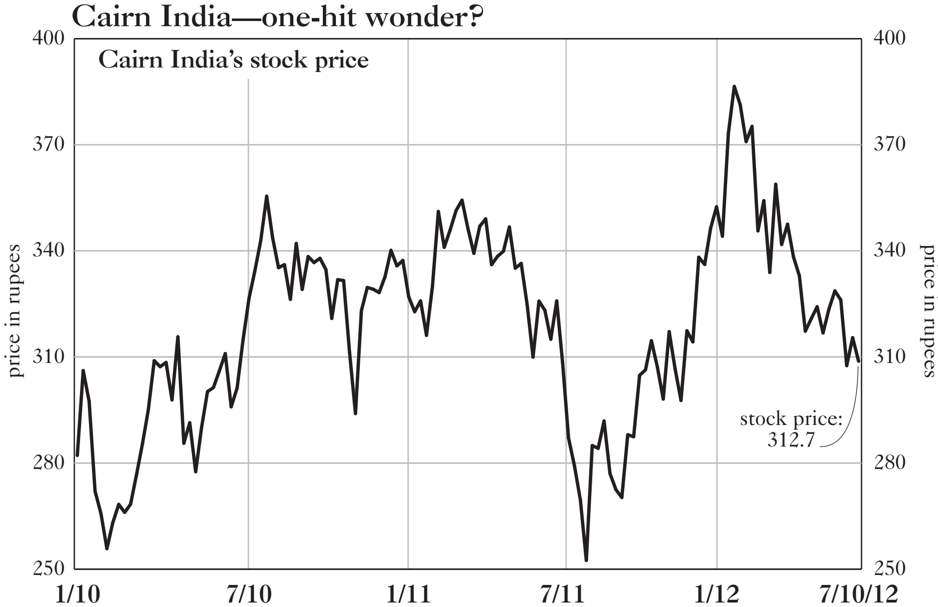
First up is Cairn Energy (CNE on the London Stock Exchange), a £1.66 billion ($2.57 billion), Edinburgh-based exploration and development company that the market loves to hate. Cairn's principal asset is an 18.3% stake in Cairn India Ltd. (CAIR IN on Bloomberg), which alone is worth almost $2 billion. There are days—June 27 was one of them—when Cairn trades at a discount even to this, its top but by no means only, asset.

Insofar as Mr. Market has given the matter his due consideration, he has put down Cairn as a one-hit wonder. The company had a huge success in India, discovering, in the Mangala field in 2004, the potential source of 30% of India's current oil production. Having hit this jackpot, Cairn returned cash to its owners. Completing the sale of a 40% stake in the Indian crown jewel in December, management distributed $3.5 billion in a special dividend in February.

But Cairn did not liquidate. With the cash that remained, it bought Agora Oil & Gas, an exploration outfit with assets in the North Sea. Cost: $453 million. And it has bid for Nautical Petroleum, another E&P company with North Sea interests. Value of the Nautical bid: £414 million. Earlier, Cairn had acquired exploration acreage in Greenland equivalent to one-half the size of the U.K. Cost to date of its Greenland effort: around $1 billion.

"Let's look at valuation," colleague David Peligal proposes. "At

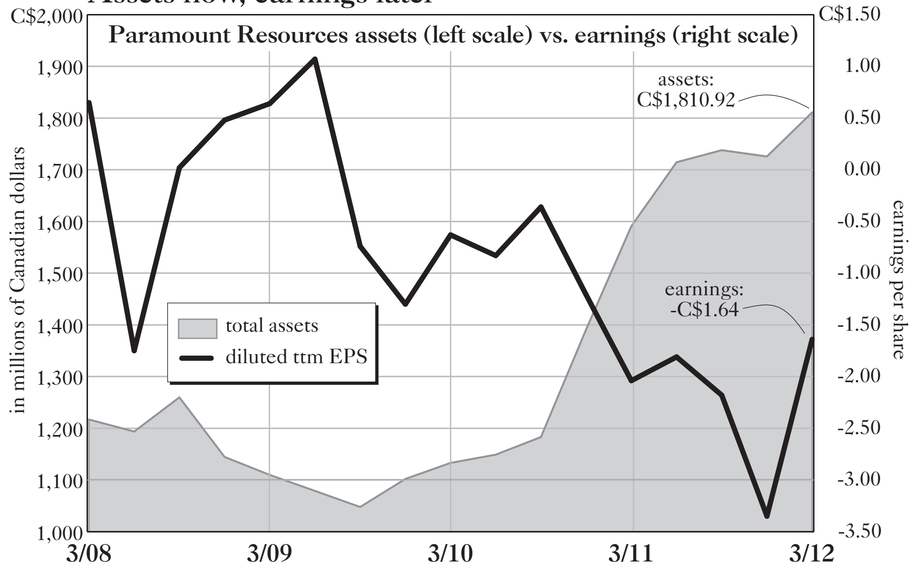
Cairn India—one-hit wonder?



source: The Bloomberg

current values for commodity prices and exchange rates, Cairn India is worth almost $2 billion. Let's assume that the Nautical Petroleum acquisition goes through. At the end of this year, Cairn Energy would have a little less than $200 million of cash plus another $360 million that came in from the most recent disposition of Cairn India shares in late June (it has no debt). Adding the value of the remaining Cairn India position to pro forma year-end cash gives an amount roughly equal to Cairn Energy's current market cap. Consider the free options. True, the Greenland effort has so far yielded nothing but dry holes, but, as the geologists say, there's just a lot of potential stuff up there. Two, there are some exploration blocks in offshore Spain. Third, we've got Agora and Nautical, the latter trading slightly above Cairn's bid price as if to suggest that someone thinks it has value."

Assets now, earnings later



source: The Bloomberg

There are, of course, risks, but the market seems to have overlooked the potential rewards. "Should their failure thus far in Greenland render their success in India meaningless as an indicator of future exploration potential?" asks Jeremy Mindich, managing member of Scopia Capital and a Cairn Energy holder. "We don't think so."

Like Cairn Energy, Paramount Resources Ltd. (POU on the Toronto Stock Exchange), a Calgary-based oil and natural gas development and production company with operations in western Canada, is a sum-of-the-parts story. Earnings may not be much, the narrative goes, but the undervalued assets will sooner or later validate the foresight of the management and the patience of the investors.

At 85.6 million shares outstanding times a C$24.17 share price, the Paramount market cap weighs in at C$2.07 billion. The company boasts, among other things, a new oil sands subsidiary headed by Will Roach, former president and CEO of UTS Energy Corp. (*Grant's*, Sept. 19, 2009). Cavalier Energy is its name, and it's the recent proud acquirer of 36 square miles of land encompassing a prospect called Eagle's Nest: "We bought that out of bankruptcy from Oilsands Quest earlier this year," Roach tells Peligal. Then there's the promising Paramount tract in the Liard Basin, a relatively unexplored area of northeastern British Columbia. Eric S. Stein, founder of ESS Capital Management, paid-up subscriber to *Grant's* and owner of Paramount shares, has some thoughts on the Liard Basin property.

"The biggest recent development," Stein tells Peligal, "which I think is one of the keys to the company's intrinsic value and that nobody is really focusing on right now, is that Apache Corp., at their investor day last month, announced that they had discovered 48 trillion cubic feet of recoverable gas. Apache thinks this is the best unconventional shale reservoir in North America. The initial production rates are off the charts, and they've said that this play, because the production rates are so strong, is probably economic at

$2.57 per mcf, which is where Henry Hub gas was priced just a few weeks ago. My view is that it doesn't really matter, because Liard is about 60 miles from the Horn River Basin. And the Horn River is being talked about as the big gas supply field for the LNG facilities in Canada. Obviously, Asian LNG is between $14 and $16 per mcf. Paramount believes they have about 15 trillion cubic feet of recoverable gas in the Liard Basin, which is not in anyone's sum-of-the-parts models. My view is that if you assume that they bring in a JV partner, which is what a lot of these operations have done up in the Liard and Horn River basins, their recoverable gas, net to them, goes from 15 tcf to 7.5 tcf. If you value that resource in the ground at about $0.20 per mcf, that's worth about $1.5 billion, or C$17 per share to Paramount. And that's just one of their assets."

Paramount's management team and ownership interest constitute another corporate asset. Clay Riddell, chairman and CEO, founded Paramount in 1974. Jim Riddell, his son, is president and chief operating officer. The Riddells own half of the stock and run the company with refreshing indifference to quarterly results. "They run it like a private company," Burt Ahrens, president of Edgehill Corp., an investor in energy stocks, tells Peligal. "When Paramount has a new area that really seems prospective, they invest in the infrastructure as well as drilling the wells. This may have a negative impact on earnings per share, but it pays off handsomely when they go into production."

As of the March 31 reporting date, Paramount showed net debt of C$474 million, and its public investments are worth C$625.6 million today. The investments can be seen as a source of cash with which to finance exploration and development outlays. These may run to C$475 million in 2012, management reckons. Besides the aforementioned long-lived assets in Liard Basin and Cavalier, Paramount is producing 25,000 barrels of oil (or oil equivalents) a day; 2012 revenues may come in at C$250 million. Analysts forecast a loss of C$0.80 a share.

"So, net-net," Peligal sums up, "this is what Paramount offers: valuable resources in the Liard Basin that might feed a future Asian LNG export trade. You have those public investments and a smart and well-respected management team that is investing alongside you. And you have the likes of Will Roach at Cavalier whose track record of success preceded him at Paramount."

Now for a postscript on ATP Oil & Gas Corp. Concerning its 11 7/8s second-lien notes due May 2015. *Grant's* had bullish things to say in the issue dated July 23, 2010. Quoted at 72 when we wrote, they fetch 47 today. They're rated Caa2/CCC-minus.

Peligal has surveyed holders of the ATP notes. He has appraised the value of the ATP assets and taken the measure of the unstellar ATP management team (whose latest misadventure featured the resignation of a new CEO exactly one week after that executive, Matt McCarroll, reported for duty). And what we conclude is that, if ATP did file for bankruptcy, the price of the notes probably wouldn't fall by much and could, in fact, appreciate a little, since management, bankruptcy-bound, would be making fewer new dubious commitments. For ourselves, who misjudged two years ago, we don't see much upside, and we don't see much downside. We are neither bullish nor bearish but chagrined.

•

Block trade

(February 24, 2012) "Among other steps," said Federal Reserve Bank of New York president, William Dudley, in a Jan. 6 speech enumerating some of the possible ways out of the long-lingering bear market in houses, "investors could be encouraged to purchase REO [i.e., real estate owned by the lender] to be made available as rental housing." He took the words right out of our mouth. Now unfolding is a survey of opportunities in the asset class that most Americans have had quite enough of.

Since the boom went boom, these pages have featured bullish accounts of houses for sale in a variety of exotic settings. We have sung the praises of the bargains on offer in Detroit, Marco Island, Fla., Fishers Island, N.Y., and the rocky Maine coast, to name a few places in which most people do not, in fact, live. We now turn to ordinary single-family houses in prosperous southeastern cities. Buy them and rent them is the business plan. What this narrative may lack in shock value, it will perhaps make up for in arithmetic.

We build our bullish case on three principal observations. No. 1: To judge by the evident peak in mortgage delinquencies, the worst of the housing bear market is over. No. 2: To judge by the upcreep in the rental component of the Consumer Price Index, the rental market is tightening. No. 3: The 33% decline in the average house price from the 2006 peak itself compensates today's buyer against many of the risks inherent in home ownership. Risks, of course, there will always be, including the possibility of continued subpar economic growth and the chance that the selling by the baby-boom generation (10,000 of the old codgers are expected to retire each and every day for the next 19 years) will overwhelm the buying by the so-called echo-boom generation. However, housing starts have fallen off a cliff, residential investment as a percentage of GDP has dropped to a record low and housing affordability has pushed to an historic high.

The bull case on the single-family American home can boast some thoughtful and well-funded adherents. Och-Ziff Capital Management Group and Oaktree Capital Management are only two of them. On Jan. 11, Waypoint Real Estate Group, the nation's leading acquirer of distressed, single-family properties, and GI Partners, a Silicon Valley-based private-equity firm, announced a significant equity investment by the latter in the former. "The GI investment will initially enable the acquisition of more than $250 million in single-family rental homes," said the Waypoint press release, "and is anticipated to ultimately support the acquisition of more than $1 billion in single-family rental homes over the next two years," assuming, that is, some modest application of leverage. The Bay Area and Southern California are Waypoint's current favored hunting grounds. The new investment will finance a thrust into Phoenix and Las Vegas.

The single-family house is what one might call an asset class on the make. With an adequate down payment and pure-as-driven-snow credit qualifications, an individual can buy a house or two or three. To buy an institutional-size lot of houses is quite another matter. Colleague David Peligal put the question to Rick Magnuson, executive managing partner of GI Partners and chairman of Digital Realty Trust (DLR on the New York Stock Exchange): What is the catch? That is, what do prospective investors in orphaned houses commonly overlook?

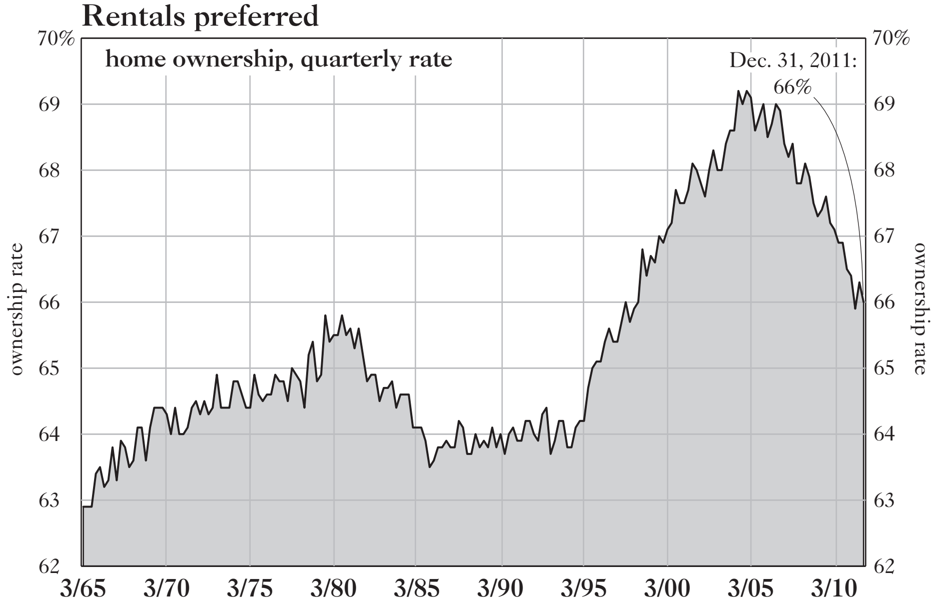
"They miss," Magnuson replies, "the frictional costs of the traditionally people- and paper-intensive real estate industry. The process needs to be automated from purchase through the rental agreement, or fixed costs will be very high. High fixed costs drive up the ultimate cost of the home and, because the rent is set by the market, drive down the resulting yield to the investor. The real estate industry, when you sell a house, has been very people intensive. That's fine for an expensive house, but when you're buying six houses per day, the overhead could drive the yields to unacceptably low levels."

Which brings us to Aaron Edelheit, a 37-year-old former value-stock picker turned professional home buyer. Before he took a shine to houses, Edelheit was the general partner of the Sabre Value Fund. Over $9\frac{1}{2}$ years of operation from 2002 to 2011, Sabre delivered an average annual compound return of 9.9%, with maximum assets under management of $20 million. Edelheit says he got his real estate epiphany in 2008, when he bought a four-bedroom, two-bathroom house in Charlotte, N.C. (situated 20 minutes from the airport and 15 minutes from downtown) for $75,000 and rented it out for $1,000 per month.

"Excited by a 16% gross yield—a very gross yield, as we shall see—as the rest of the investment world was falling apart," Peligal relates, "Edelheit thought there might be a real opportunity to create a partnership to invest in single-family rentals. Even though raising money to purchase single-family rentals was not the most popular investment strategy in March 2009, Edelheit did form a partnership, raised $1.3 million and purchased 22 additional houses in Charlotte. Initially, he thought it was just a side business. But, about six months later, an investor prevailed on him to start another, separate partnership, which the angel investor funded with $11.5 million over the next year and a half. Edelheit bought houses not only in Charlotte, but in Atlanta and Nashville as well. He calls his new theater of operations the 'investment opportunity of a lifetime.'"

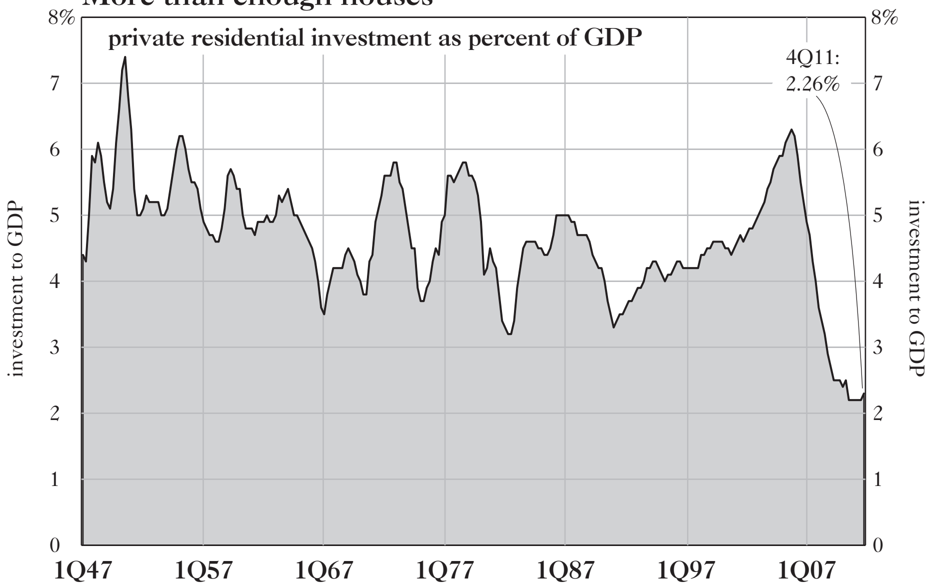
"Managing people's money in the stock market is a 24-7 job," Edelheit tells Peligal. "Once I got past 100 homes, managing that whole process is also a full-time job. I needed to make a decision and it was actually a pretty easy choice. In the stock market, I compete against algorithmic trading and the Bill Ackmans and David Einhorns of the world. In single-family homes, there's Fannie Mae and the neighbor down the street. At the core of it, it's not rocket science. Anyone can buy five or 10 homes, but to actually do it in size and scale takes an incredible amount of work because of the minutiae and the process to actually scale up. It takes technology, people and forethought. So I made the decision to wind down my hedge fund and solely focus on single-family homes. I launched my third partnership in July 2011. That's the American Home Real Estate Partnership; I ended up raising $11 million for that. The three partnerships now have $24 million and almost 300 homes. This week, we're going to launch our fourth partnership—American Home Real Estate Partnership II—and we're aiming to raise north of $25 million. That's the arc of how this came to be. Where it used to be just me and one of my employees in Charlotte, we now

Rentals preferred



source: The Bloomberg

More than enough houses



source: Federal Reserve Bank of St. Louis

have 23 employees. Where we used to outsource a lot of it, we now have our own property management company. We're putting together a platform for growth and scale."

Of course, the transition from Wall Street to single-family rentals on Elm Street takes some getting used to. "One of our biggest jobs is actually the scheduling of utilities, figuring out how to get the utilities turned on," sighs Edelheit. "It is the biggest obstacle for growth." High on the list of what might be termed unforced errors is ignoring one's mail from the homeowners' association. Let us say that your tenant's portable basketball hoop hangs four feet into the road or that you're not mowing your grass. The homeowners' association is watching. If you don't respond to the HOA notices, fines build up. And if you don't respond to the fines, the busybodies can slap a lien on your house.

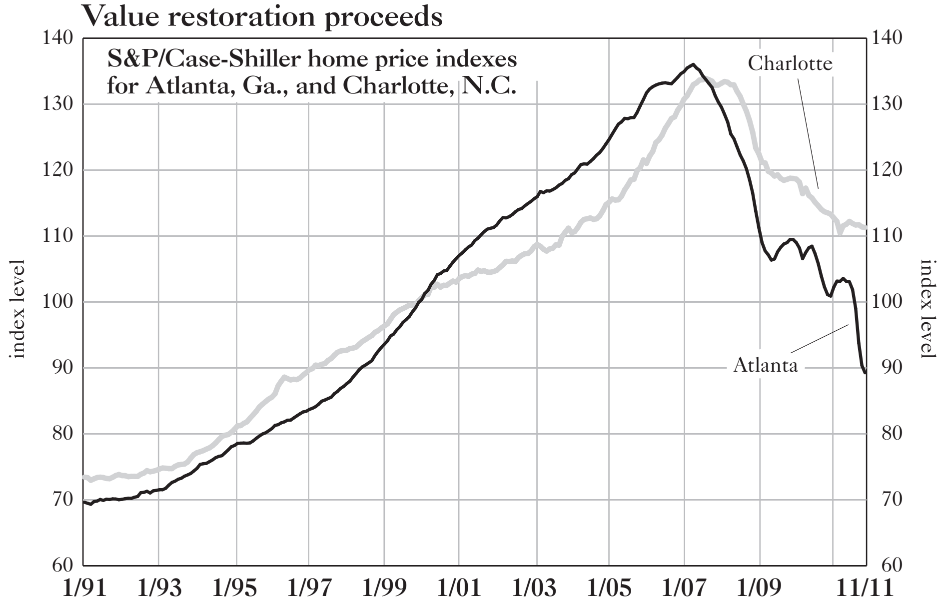
On the one hand, it does give pause that such minutiae can spell the difference between a good investment and a mediocre one. On the other, buying public equities is not without its sand traps, either. "Let's say," says Edelheit, "a couple of tenants didn't pay and we had to fix an air-conditioning unit. The monthly cash flow from this second partnership goes from $93,000 to $88,000—so the cash flow goes down $5,000. It's unlevered. That's my problem, as opposed to making an investment in a corporation where the CEO just does a dilutive acquisition, raises money and the stock falls 30%."

Persuaded that he's gotten past the proof-of-concept stage, Edelheit is on the money-raising trail. Terms are 1% and 20% with an 8% hurdle rate and a lockup of no less than seven years. And what kind of assets would fill the portfolio of Edelheit's projected new partnership? Houses situated in towns or cities featuring landlord-friendly tenant laws, a low cost of living, close proximity to colleges and universities, a high quality of life and a pro-business political atmosphere, says the head man. Atlanta and Charlotte are the archetypes, he adds. Edelheit prefers three- to four-bedroom homes in the $50,000 to $100,000 price range, marked down from $125,000 to $200,000, set in middle-class neighborhoods. He likes uninhabited newer houses—vacant, preferably, for 12 to 18 months before he takes possession. He buys houses from Fannie and Freddie, from banks, on the courthouse steps—but he buys them individually, not in lots. He uses no leverage—not that he's against debt in principle. The trouble these days, he says, is the onerous terms of borrowing. Banks want his personal guarantee, and/or that of his investors in his bigger partnerships, though the second Edelheit partnership of $11.5 million is throwing off something like $800,000 per year of net unlevered cash flows.

"Before Edelheit bids on any house," Peligal relates, "members of his staff have already walked through with checklists, taken pictures, pulled the crime report and assessed what type of repairs might be needed to get the house to rent-ready status. It takes about four months to bid on a house, close the deal, do the inspection, have contracting crews make repairs, have property management people do walkthroughs to make sure the house is ready, start advertising for tenants and—not least—find the right tenant, preferably a salaried employee."

Edelheit is as price-conscious as a former micro-cap value-stock investor ought to be. He says he paid an average of $29 a square foot, about half of re-

Value restoration proceeds



sources: Standard & Poor's, Case-Shiller placement cost, with which he stocked his third partnership, and he continues to pay more or less that price today. One of the tricks of the trade that he's prepared to reveal is the importance of bidding first. Chances are, he says, one's bid will be hit, as were his—$3 million's worth—in January. Each was an individual purchase.

"Now," says Peligal, "for a real-life example: Take a three-bedroom, two-bathroom, 1,500-square-foot house in Marietta, Ga. The price is $60,000. Call the closing costs $3,000. Repairs absorb another $12,000—new carpet and paint for $6,000; a new air-conditioning unit for $3,000 (the original seems to have walked off while the house was vacant); roof repairs, $3,000. Thus, make the all-in purchase price $75,000 against the prevailing monthly rent of $950. Taking the annual rental income of $11,400 and dividing by the total purchase price yields a gross rental yield of 15.2%. But gross is far from net. Subtract 10% of the annual rent, or $1,140, as a vacancy and bad-debt expense. Subtract another 10%, or $1,140, for property-management expense. Take out 1.3% of the last appraised value for taxes; call it $1,300. Subtract $700 for insurance. Finally, subtract 3% of the total purchase price, or $2,250, for annual maintenance and repairs. The subtraction done, what remains is net annual rent of $4,870—divided by $75,000 yields a net annual rental yield of 6.5%.

"We bulls on the single-occupancy American house anticipate more, of course: growth in rental rates, a thaw in financing, a bounce-back in the housing market and benefit from economies of scale. As Gary Beasley, managing director of Waypoint Real Estate Group, tells me, 'You get great pricing when you're doing 100 homes per month—which is what we're doing now. We have leverage with our contractors and we can buy our materials in bulk. We know exactly what it costs to drop in granite, and it's a fraction of what it would cost if you were just trying to do it on a one-off basis as a consumer.'

"Whether it's Edelheit or any of these other investors," Peligal continues, "scale is crucial for making the business model work. If there are a couple million foreclosures on the horizon, is it possible to buy 10,000 good ones? Probably. If you assume that the average value of each is $100,000, you're talking about a company with $1 billion worth of houses. Maybe within the assumed seven-year holding period, buyers and creditworthy borrowers will appear as the system becomes unclogged. Maybe a single-family REIT class will form and these portfolios will trade on yield. If one is making a 6½% net return, how might that compare to multifamily? According to Green Street Advisors, cap rates for apartment buildings today, after capital spending, average around 5% for institutional quality properties. However, whether it's from mold or leaks, houses rarely get better with age, and the level of maintenance capital expenditures is often underestimated. I asked Andrew McCulloch, residential analyst at Green Street, about cap-ex in his specific sector. 'We estimate apartment buildings require cap-ex reserves of 15% of NOI to generate rent growth that keeps pace with inflation,' he said, 'and this is for a mature asset class with experienced operators, economies of scale, national procurement contracts for parts and materials, and physical structures where units are homogenous and lend themselves to efficient operations.'"

Concerning that first house Edelheit bought in 2009, the four-bedroom, two-bath model in Charlotte: You will recall he paid $75,000 and charged his tenant a monthly rent of $1,000. It was, he believed, a commanding bargain. Today, Edelheit reckons, he could sell the house for $65,000 and get $900 to $950 a month in rent. In other words, the bear market has continued. Or, to say the same thing, the ultimate payoff has become sweeter. "That is part of what makes buying now so amazing," says Edelheit, more bullish than ever.

•

When in Athens

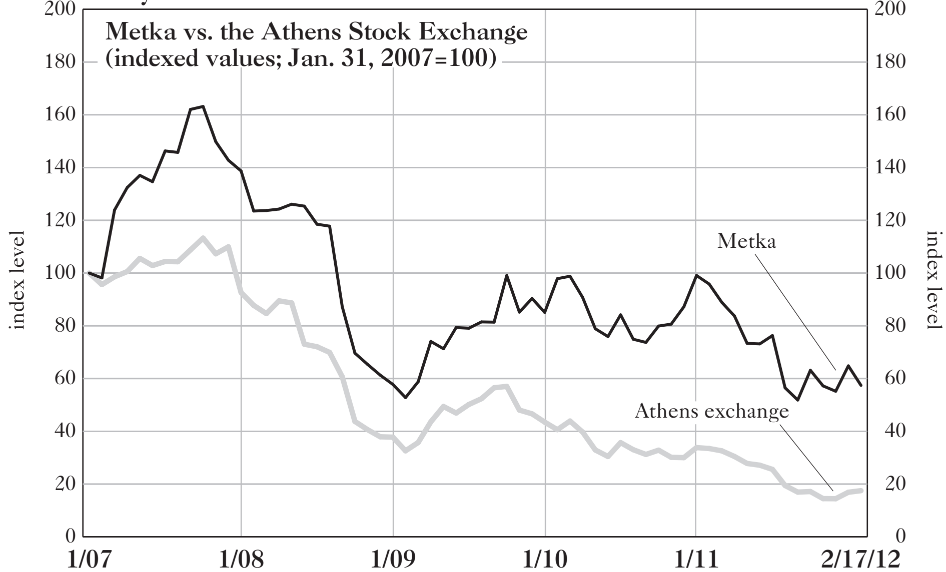
(February 24, 2012) For advice on how to invest in crisis-torn Greece, we turn to a man who navigated hyperinflationary Zimbabwe. "You have to think of which kind of companies would be standing no matter what happens," Francis Daniels, portfolio manager of the London-listed Africa Opportunity Fund, advises colleague Evan Lorenz. Look for profitable, lightly leveraged exporters, Daniels continues. Identify a business that would actually gain from devaluation—but don't overpay for it. If 20% is a not unreasonable cost of capital in a country suffering 21% unemployment and a peak-to-trough plunge in real GDP on the order of 16%, five times earnings or less is the correct valuation for a Greek investment candidate.

Taking Daniels's counsel to heart, we fix our sights on Metal Constructions of Greece, S.A., better known as Metka (METTK on the Athens bourse). An internationally competitive engineering, procurement and construction business—EPC to the cognoscenti—Metka checks every one of Daniels's boxes. Profitable in each of the past 20 years, the company shows €2.27 in net cash per share, fully 36% of the €6.22 share price. It generates the great bulk of its revenue outside Greece, and non-Greek customers account for more than 90% of its €1.9 billion order backlog. If and when the Greek national currency displaces the single European currency in the Hellenic Republic, Metka would be in the happy position of earning most of its income in dollars and euros while paying its Greek engineers (and meeting its corporate-overhead expense) in drachmas.

Then there's the valuation box. The shares are quoted at 3.3 times trailing net income and 1.5 times enterprise value to earnings before interest, taxes, depreciation and amortization. In a Nov. 30 report, HSBC analyst Paris Mantzavras marveled that the sum of net cash and actual and estimated discounted cash flows from 2011 through 2013 topped the then-current market cap, as they still do today: "It's as if the market assumes no value creation post 2013, i.e., as if the company were to be wound down thereafter." The *Grant's* working hypothesis is that there will, in fact, be a Metka in 2014.

Let us just say that METTK won't be everyone's idea of a core institutional investment, its 7.7% dividend yield—covered nearly four times by net income—notwithstanding. Though the corporate top line exceeded €700 million in the first nine months of 2011, there are just 52 million shares outstanding of which 56.2% are held by parent Mytilineos Holdings (MYTIL in Athens). Then, too, the venturesome holders of Metka must do more than pay lip service to the famous Rothschild dictum of buying when there's blood in the streets. The fact is, in the first nine months of 2011, Syria generated 28% of corporate turnover (though, as we shall see, Metka takes

Baby and the bathwater



source: The Bloomberg

sensible precautions against sovereign credit risk). Besides, the EPC business is lumpy and risk-fraught by nature. "The No. 1 challenge, the No. 1 risk is always execution," Dimitrios Katralis, parent Mytilineos' investor relations officer, tells Lorenz, "because there's always something that can go wrong with a project and you will find yourself paying penalties. It has not been the case so far. We want to keep it like this."

Founded in 1962 as a manufacturer of metal parts for the construction industry, Metka makes its living today building gas-powered electrical plants in Eastern Europe, the Middle East and North Africa. Some 95% of its revenue in the first nine months of 2011 derived from the engineering, procurement and construction of turnkey power-plant projects. "Since the possibility for new projects of this kind in Greece is rather small," Merit Securities analyst Nikos Christodoulou observes to Lorenz, "they took over significant projects abroad and built a very good name. Metka will continue to derive more than 90% of its sales abroad for the visible future."

Because Metka must replenish its €1.9 billion backlog with new work every year to sustain its current pace of turnover, there's more fog than visibility. Christodoulou himself acknowledges it, projecting a decline in revenues over the next five years of 4.8% a year, compounded—"since visibility is low and therefore I have to be conservative," he says. It would be a radical reversal of form: In the past five years, revenues have grown at the compound annual rate of 25.8%. In case you haven't guessed, Metka is one of Merit Securities' top picks to click.

It's not clear how the American governance police would view the Metka-Mytilineos tie-up. Thus, Metka's chairman and managing director, Ioannis Mytilineos, is also the vice chairman of the previously mentioned Mytilineos Holdings, a diversified Greek industrial business with interests in metallurgy, energy, defense and, of course, EPC. The chairman and managing director of Mytilineos Holdings is Ioannis's brother, Evangelos. Metka pays Mytilineos Holdings for such services as public relations, investor relations and treasury functions. And for reporting purposes, Mytilineos consolidates Metka's figures.

"However," notes Lorenz, "it is clear that the brothers Mytilineos have done a bang-up job with Metka over the past 13 years. Metka's third-quarter 2011 revenue came to €241.8 million, compared to full-year 1999 revenue of just €55.7 million. In 1999, Metka was primarily a subcontractor on Greek construction projects. Today, it's the lead EPC contractor on international power projects. It's no easy feat making such a

Metka S.A. at a glance
(in millions of euros, except per-share data)

	12 mos. to Sept. 30, 2011	2010	2009	2008	2007	2006
Revenue	€ 846.1	€ 613.7	€ 339.4	€ 381.5	€ 284.2	€ 294.1
Cost of goods sold	678.4	453.9	261.3	299.5	216.3	225.9
Gross profit	167.7	159.8	78.1	82.0	67.9	68.3
Operating expenses	34.6	30.8	22.3	20.4	15.7	12.4
Operating income	133.1	129.0	55.8	61.5	52.2	55.9
Interest expense	13.1	8.8	3.1	4.1	2.2	0.4
Other	(6.8)	(5.2)	(1.9)	(0.5)	(0.4)	0.7
Profit before tax	126.9	125.4	54.6	58.0	50.5	54.9
Taxes	28.4	36.2	17.6	13.2	13.2	14.4
Net income	98.4	87.0	35.2	41.4	36.8	40.6
Minority and other	1.8	2.1	1.8	3.4	0.5	(0.2)
Net income to common shareholders	96.6	87.0	35.2	41.4	36.8	40.6
EPS	€ 1.86	€ 1.68	€ 0.68	€ 0.80	€ 0.71	€ 0.78
Cash and equivalents	149.4	68.3	31.3	17.7	27.3	5.0
Debt and minority interests	31.3	19.3	26.7	26.9	30.4	13.9
Net debt	(118.1)	(49.0)	(4.6)	9.2	3.2	8.9
Total assets	954.3	807.7	482.8	335.0	353.5	225.8
Cash flow from operations	72.5	52.3	36.6	22.4	42.8	0.1
Capital expenditures	(4.2)	(4.2)	(2.5)	(1.8)	(2.5)	(3.8)
Free cash flow	68.3	48.1	34.1	20.6	40.2	(3.7)

source: The Bloomberg

transition. Power companies, naturally risk averse, aren't in the habit of taking flyers on untested vendors.

"Mytilineos established Metka's reputation by seeding Metka with work," Lorenz goes on. "This experience Metka duly built on to win more work, first with the Greek government-controlled utility, Public Power Corp. (PPC on Athens), and later alongside General Electric, whose turbines it had placed in Mytilineos's power plants. In 2007, Metka and GE entered what proved a successful joint bid to build a 220-megawatt power plant in Karachi, Pakistan. From that first international success, Metka has won work in Romania, Turkey, Iraq—and, more worryingly, Syria."

Lorenz asked Katralis about the financial risk attendant on such commitments. Certainly, Syria is nobody's idea of a triple-A-rated Canada. "[W]e won't start any operation without a letter of credit in place," the Mytilineos IR man replies. "This is the case with the Syrian project that we have. All the money is guaranteed through this letter of credit and it is through a triple-A western bank" (or, perhaps, Katralis means a formerly triple-A-rated western bank, the last of that superlative breed, Rabobank, having been downgraded by Standard & Poor's in November). However, though there is no apparent risk of Syria not paying, there is considerable uncertainty as to how fast the work may be allowed to proceed. Anticipating delays, analysts on the Metka case have penciled in a 20% decline in 2012 earnings per share.

In the early going, Metka agreed to pay Mytilineos 3% of its top line for the corporate services already noted. However, in view of last year's mushroom growth in its junior's revenues, Mytilineos has agreed to make do with a flat €6 million a year, instead. Then, too, the parent is helping its fast-growing charge to develop a new line of business. A Metka power-plant service and maintenance division is today generating small returns at a pair of Mytilineos plants. How nice it would be, a Metka shareholder may reflect, if the company's quite spectacular, but necessarily irregular, EPC revenue could be supplemented by a strong and steady source of recurring income.

All of which invites a question that Lorenz put to the parent's spokesman, namely, why doesn't it buy up the rest of the stock in its precocious child? The market value of the minority interest, at €6.22 a share, amounts to €142 million. Of course, one would have to pay a premium to the current price, but it would seem to fall short of a king's ransom. "When you have money, the price doesn't seem right," Katralis explains. "For example, today, you must be very careful using money in Greece. All the companies want to keep their liquidity. It would be very hard for Mytilineos to do a cash acquisition of Metka. Metka also has very long-term and loyal shareholders, but they wouldn't be happy to give up their shares at the current levels."

The televised images of rioting Athenians vividly illustrate only one aspect of life in present-day Greece. Metka exemplifies another. Between calendar 2007 and the 12 months ended Sept. 30, 2011, its corporate revenues have surged by 198%, national catastrophe notwithstanding. It could well be, of course, that a Greek sovereign default would knock every listed Greek company for a loop. In which case, Daniels, the old Zimbabwe hand, has some advice. "You have to be prepared for pain," he says, "and what you do rather than cut back on your position, if your position is right, is you take advantage of the pain and actually add to your position and average down."

Nothing to it.

•

America's people power

(February 10, 2012) Love and marriage—and interest rates, too—are among the foremost drivers of nonagricultural land prices. Without population growth and ready financing, the asset once stockpiled by leveraged homebuilders yields only weeds and tax assessments. Now unfolding is a primer on uninhabited acres. In preview, we're bullish—at a price.

People hold the key to this market as they do to every other. From the standpoint of the land on which developers build, you can hardly have too many people. Lots of growing families are what a landowner roots for—that and growing incomes and an end to the alarming trend of adult children returning home to live under the parental roof.

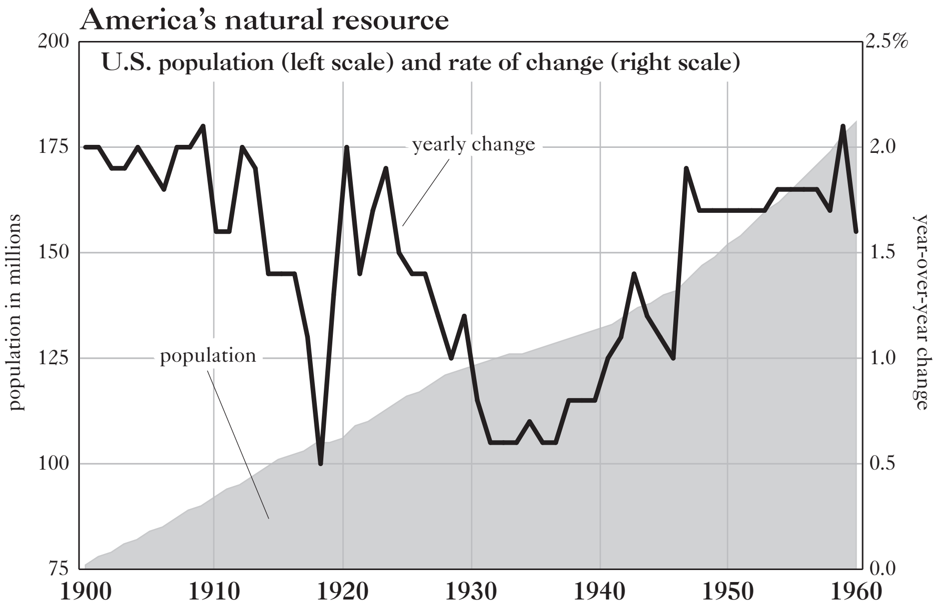
You, Mr. or Ms. *Grant's* Subscriber, may or may not be a landowner, but you assuredly have an interest in the forces that push land values up or down. It happens that the foremost of these influences is the one in which this country enjoys a competitive advantage. Respectable population growth is what America, alone among the world's big economies, is currently registering.

The population of the United States stands at 313 million today. That's Democrats, Republicans and independents, citizens and all others. If United Nations' forecasts are on the beam, our numbers will increase by 26.7 million between 2010 and 2020 and by 92.7 million between 2010 and 2050.

In comparison to the outlook for the other major economies, America is the world capital of fecundity. Thus, say the U.N. demographers, Japan's population will shrink by 0.14% a year to 2020 and by 0.37% between that year and 2030. Europe's will grow by 0.08% til 2020, before declining by 0.04% through 2030. As for Germany, the great white hope of the old Continent, its numbers will shrink by 0.16% a year through 2020 and by 0.19% a year through 2030. China, too, with its one-and-only child policy, is on the demographic skids, with projected 0.34% growth to 2020 and 0.04% a year through 2030 (the former Red China is slated to begin contracting after 2025). Compare and contrast the United States, whose numbers are forecast to grow by 0.83% a year through 2020 and by 0.71% a year through 2030.

One takes these forecasts with a grain of salt, of course. In the late 1930s, Harvard economist Alvin Hansen preached the doctrine of "secular stagnation." America was fresh out of innovation and enterprise, reasoned Hansen, who had no inkling of what lay just over the temporal horizon. Failing massive federal stimulus, the professor insisted—they called him "the American Keynes"—the economy would stand stock still. Population growth had dwindled in the 1930s to a rate of 0.7% a year from 1.5% in the roaring 1920s. But then came the postwar prosperity and the storied reacceleration in American births. Between 1946 and 1960, America's population grew at a compound annual rate of 1.8%. It out-roared the 1920s.

Though the future is forever a closed book, we can guess. To forecast the number of 15- and 20-year-olds a decade hence, count the number of five- and 10-year-olds today. "The birth rate and net immigration numbers will



source: Historical Statistics of the United States, Colonial Times to 1970

be what they will be," observes Evan Lorenz, the in-house demographer. "Prospective parents are more likely to bring new life into the world in a time of economic growth than otherwise. Foreign workers are more likely to emigrate when there are jobs. If the 1.5% rate of population growth in the 1920s had been sustained through the bleak 1930s, there would have been 7.9% more Americans in 1940 than the Census Bureau actually counted. So we can predict the number of 20-year-olds in 2030 with a small margin of error—a margin that increases as we try to forecast the number of 15-year-olds."

The more economically sensitive figure to know is the number of 15- to 64-year-olds. Without working-age people, after all, there can be no work, as Japan is coming to understand. Owing to a relatively old population (median age in 2010 was almost 45 years) and a small cohort of the very young, the number of employable Japanese is expected to decline even faster than the Japanese population as a whole. "Assuming," as Bank of Japan Governor Masaaki Shirakawa addressed an audience of business leaders in Nagoya late last year, "that labor market participation by the elderly and female population remains unchanged, based on long-term projections of demographic trends, the rate of decline in the number of workers will accelerate further to 0.6% in the 2010s and 1.3% in the 2030s.... Assuming that productivity growth is around the average of the last 20 years, that is, around 1%, the annual rate of economic growth for the 2010s onward will ultimately remain between 0.0% and 0.5% on average and enter negative territory in the 2030s." The central banker was likely not surprised at the news that Japanese office rents fell by 3.7% last year to the lowest level since at least 1990.

Though demographics are not to be confused with destiny, we can apply the Shirakawa model to countries outside Japan. Thus, in the decade to 2020, America's working-age population is expected to grow by 0.4% a year, Germany's to contract by 0.5% a year. Within the limitations of the Shirakawa approach, America would therefore generate real growth of 1.31% a year, less than half the 2.7% registered from 1980 through 2011. Yet even this snail's pace of progress would be more than double the 0.45% real growth toward which Germany would be demographically pointed.

People need roofs over their heads, and America has roofs to spare, of course. By overproducing and over-financing houses in the early and mid-2000s, this country created its own Hansen-like stagnation. However, we Americans have not forgotten the art of baby making. Thus empowered, we are collectively setting in motion one of the solutions to the crisis of the redundant roofs.

The estimated overhang of unsold houses in the 50 states today stands very roughly at 4.1 million. This includes dwelling places listed for sale, in foreclosure and otherwise held off the market by hopeful, or undercapitalized, creditors. It is a big and worrying number. However, it equals 92% of the projected growth in the number of working-age Americans in the next five years. Though procreation represents no certain fix for the housing problem, it may prove more potent than quantitative easing.

It would be nice to know the starting date of the next broad-based upturn in residential real estate (just the year would do). Naturally, to the would-be buyer of a negative-carry asset, sooner is better. Not knowing when, the prudent investor must seek a margin of safety. For Avanti Properties Group, the Winter Park (Fla.)-based investor in land that someone may want to build on some day, the critical source of safety is the price it pays.

When we last checked in with Avanti—CEO Marvin Shapiro and co-chairman Charles Schwartz—it was November 2009 and the world was dark. For the speculative purchase of surplus land, there was no capital and no interest. Of the $491.2 billion of construction and development loans on the balance sheets of FDIC-insured banks, fully $74 billion, or 15%, were noncurrent. By Shapiro's and Schwartz's reckoning, it had been eight years since the American residential real estate market slipped its moorings, 2001 being the year when the growth paths of house prices and household income began to diverge. The price trend, with a friendly assist from the Federal Reserve, proceeded to lurch to the upside. This was, however, yesterday's news, as house prices and incomes had finally begun to reconnect. "Now," said Shapiro two years ago, "in most locations we are in—Florida, California, Arizona, Nevada, Atlanta and a couple of others—I think housing prices have gone below the rational levels."

And today? Because some hedge funds view raw land as a winsome alternative asset, Avanti has seen some unwanted competition. Nonperforming C&D loans nowadays foot to $37.1 billion, or 14.6% of total C&D loans (measured progress there). And houses—so this publication believes—have become one of the commanding investment bargains in America. We cite in support of this contention the Burch Ratio, a calculation devised in the bubble year 2005 by reader R. King Burch. Multiply house sales by the average house price and divide by GDP. Behold: a handy reading of the temperature of the housing market. Needless to say—you can just look at the graph—the overheated market of the mid-2000s has turned into the recently ice-cold, now-thawing market of 2012. Burch himself, let us hasten to add, draws no bullish conclusion from his own construct. "I no longer have a finger on the pulse of the real estate market," he writes, "but my presumption is that there is still much inventory yet to be foreclosed. . . ."

"[I]t is," the December 2011 Avanti Properties Group newsletter avers, "always darkest before the dawn. And beginning with a few glimmers in 2010, some noteworthy signs of growth emerged this year. For example, in housing, mortgage delinquencies are declining from their high levels of 2007 through 2009 and are now falling rapidly across the country. Mortgage rates remain historically low. New-home inventory is at its lowest level in four decades. While high rates of foreclosures may cause further price declines, they are not adding to supply. . . . Against this backdrop of historic affordability and minimal supply, the seeds of renewed demand are sprouting because America's population continues to grow."

Much has changed since 2009, but some things have remained the same. For instance, according to Shapiro and Schwartz, banks are still reluctant to liquidate land, or the nonperforming loans secured by land, at realistic bear-market prices. In part for that reason, they investigate much more than they invest. Even in 2009, they said "yes" to no more than one deal in 250, and the hit rate is even lower today.

Founded in 1992, Avanti had generated an average net return of 10.3% in seven partnerships through November 2009. We quoted the officers then as saying that, thanks to the opportunities afforded by the bear market, future returns would likely be higher. They sound more bullish today. Low prices alone augur good things, but the bear market has bestowed other gifts, including a better grade of asset. In normal times, says Shapiro, a value-conscious land buyer would have to settle for property on the edge of development, waiting for the flood tide of growth to wash up on his boundaries. However, in these abnormal times, he continues, Avanti has been able to buy semi-finished lots in the very midst of development—"infill opportunities," or "interrupted developments," as he calls them.

Fieldstone, a 260-acre residential development in Fort Bend County, west of Houston, was interrupted by the bankruptcy of Kimball Hill Homes, its progenitor, in April 2008. Avanti picked up the property, comprising, among other things, 191 finished lots, 938 future lots and an "amenity center," for $14.5 million late in 2010. Included in the purchase were $12 million in bond receivables under a municipal utility district program. While Kimball bore the expense, Avanti will reap the windfall as houses are built on the finished lots. Those lots will bring in $6 million, Shapiro said (about 100 have been sold already). Add in the $12 million of bond proceeds and another $25 million in projected sales of 938 future lots, net of costs—all told, a $43 million payoff, if all goes according to plan, on an investment of $14.5 million.

With an assumed holding period of up to a decade, Avanti is the very epitome of the low-frequency investor. As bullish as the tone of their brochure copy might be, the CEO and co-chairman talk as if they have made terms with this banged-up world as it is. For instance, they say they are counting on a rate of new-home construction no better than two-thirds of the bubble-era rate. "[W]e think that happens somewhere between 2013 and 2015," says Shapiro. "Then, of course, you have a lot of time for properties to absorb from there. Most of our properties, we think, mature three to 10 years from now—the ones that we are underwriting today."

We asked what kind of price-per-acre Avanti was willing to pay.

Hard to say, Shapiro replied, every piece of ground being a little different. But take the case of a house on a lot in a generic sun-belt location. The house would sell for $200,000. The raw, unimproved ground underneath the house would fetch $15,000; the improved lot—improvements being necessary—would be worth $40,000. He said that Avanti would pay no more than $5,000 for that piece of unimproved ground. At the unheavenly peak in fake values, Shapiro recollects, the house would have sold for $250,000 to $275,000 and the unimproved ground for $30,000. So there has been progress, after all, in these past post-bubble years.

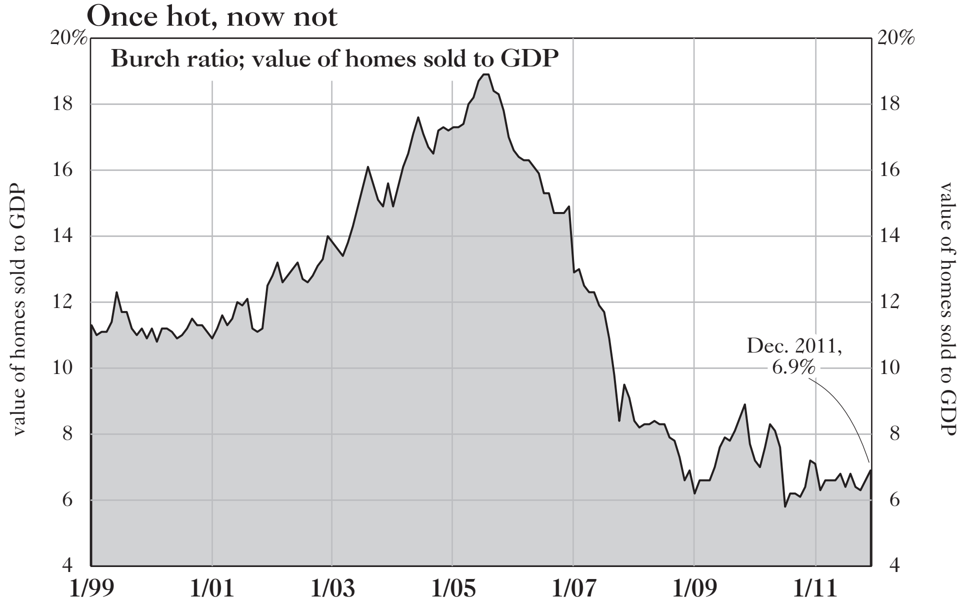
Finally, say Shapiro and Schwartz, not the least fetching aspect of the raw land market is its inefficiency. Information is not universally disseminated (neither is judgment). Yes, there's a certain amount of irksome, price-insensitive competition in the residential side of the business but next to none in the nonresidential side.

Avanti uses little or no leverage, and we asked if that was a result of a hard-learned lesson or rather from the hard-wiring of their own brains.

"We try to learn most of our lessons from watching our competition," Schwartz replied.

●

Once hot, now not



source: The Bloomberg