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Nikkei put warrants

The wonderful Herbert Stein remark about patience—"If something can't go on forever, it won't"—has been as good a motto as any to lose money by in this epic bull market. In general, things that can't go on forever have kept right on going. Donald Trump, "trophy" hotel prices, leveraged cable-TV companies, Wasserstein Perella & Co. and the Japanese stock market all come annoyingly to mind.

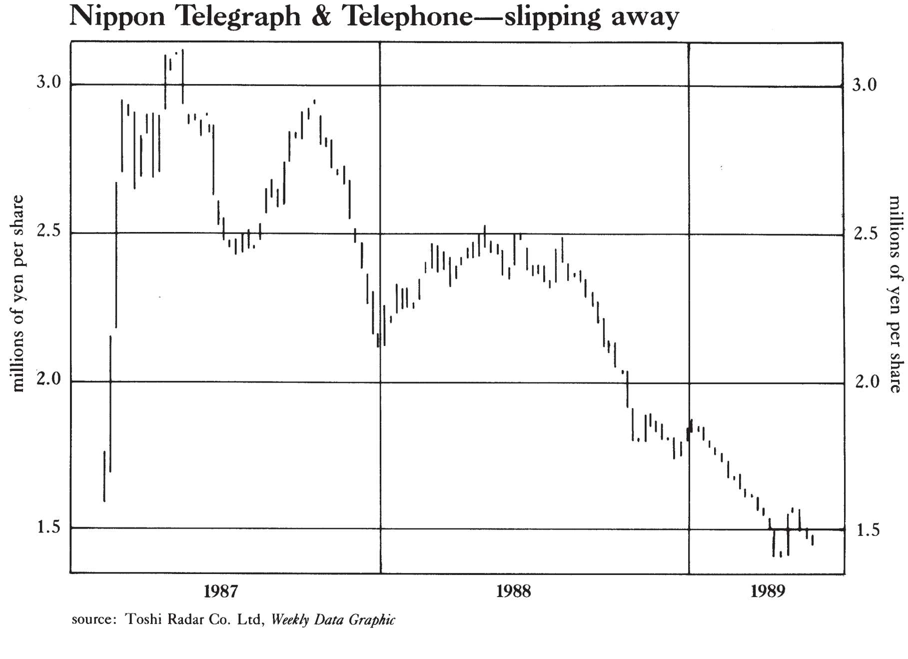
However, the inevitable can happen, even in the roaring '80s—the break in Integrated Resources is proof—and the Japanese market may yet have its well-deserved comeuppance. If so, you will want to be prepared. Ahead of time, you will want to investigate a little-known series of put warrants on the Nikkei Stock Average. The warrants were issued by Salomon Brothers International. They are relatively liquid (an advantage over the so-called European-style puts issued by some New York brokerage firms) and offer impressive leverage if worse should ever come to worse. By the way, Salomon has also issued a number of Nikkei call warrants. We report this fact for the sake of journalistic balance.

One potential legal obstacle: The warrants were not registered with the Securities and Exchange Commission, and a prospectus states flatly that they "may not be offered, sold or delivered directly or indirectly in the United States . . . or to United States persons." This language may not be the last word, though. Warrants were issued as long ago as June 1988, and your lawyer may opine that they are "seasoned" and eligible for purchase by a United States person like you. For any American so bearish on the Nikkei that he or she is contemplating a change in citizenship to accommodate a leveraged investment program, the most desirable destination would seem to be Luxembourg. Some of the warrants are listed on the Luxembourg Stock Exchange.

Every faithful reader of *Grant's* can recite the basic bearish case for Japanese stocks in his sleep. The arguments are familiar, even shopworn, but they may yet carry the day. We note, for instance, that our advance-decline line recently made a new low (see page 10)—a mirror to the fact that, whereas the Nikkei 225 -stock average has been going up, many individual stocks have been going down. Then, too, the Japanese political establishment is losing its grip on events, and the Ministry of Finance has made it harder for the big four brokerage firms to manipulate stocks (no one firm is allowed to generate more than 30% of the, trading volume in any one stock on any one day). The accompanying graph of No Securities is suggestive of a chill in the speculative climate. Note that the price peaked in April 1987. And Japanese interest rates have turned higher—in late June, the prime vaulted to 4 1/2% from 4 1/4%. A short, sad item from *The Japan Economic Journal* caught the spirit of the times:

> The option of allowing foreigners to hold shares of Nippon Telegraph and Telephone should be examined when considering Japan's communications policy and NTT's future, Prime Minister Sousuke Uno said

Nippon Telegraph & Telephone—slipping away

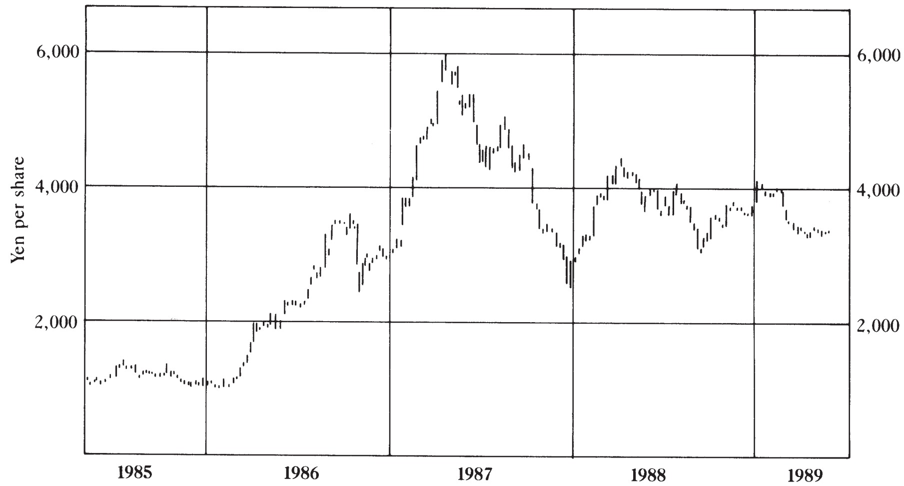


source: Toshi Radar Co. Ltd, *Weekly Data Graphic*

June 9 at the Lower House plenary session. Foreigners have not been allowed to buy the share. However, since it has fallen to a low level, the government might possibly allow foreigners to buy the share.

Alternatively, foreigners may choose to buy the Salomon. Let's look at the 28,000 strike-price series. It's the oldest of the three—issued on June 22, 1988, to expire on June 19, 1991—and has, naturally, the lowest strike price. We say "naturally" because the Nikkei does tend to go up, demoralizing the bears and taking their money. The offering price of this first Salomon issue was 28 1/4. It was quoted the other day—some 5,000 Nikkei points higher —at 4 1/2. It is the put-holders' conviction that the bullish spell will break within the next two years.

Nomura Securities—a peak years ago



source: Toshi Radar Co. Ltd., *Weekly Data Graphic*

The arithmetic of the speculation is easy. Break-even is 28,000 (actually, 28,139) on the Nikkei average on the 1991 expiration day. Let's say that that expiration day finds the Nikkei average at 14,000. That is a big assumption, but it is perhaps no more unreasonable than 33,000, the current level. What would the warrants be worth? Just subtract 14,000 from the strike price, 28,000. Result: 14,000. Divide by the exchange rate—let's take 140. Result: 100. That happens to be the price—*in dollars*—of each warrant. So if the Nikkei were to plunge to 14,000, one's $4.50 investment would produce $100. That is without considering any time value that the warrant might have.

The other two Salomon warrants have somewhat higher strike prices. They are the 31,000 series (expiring Aug. 7, 1990) and the 33,000 series (expiring April 24, 1992). As you will see if you work through the arithmetic, however, neither offers as gaudy a return if the bottom falls out. Let's examine the same hypothetical case with the 33,000 series. The strike price minus a 14,000 Nikkei average would yield a price per warrant of about $136. That is a nice-sounding price except in comparison with the current price of the warrant—about $14.20. A collapse to 14,000 would therefore fetch a return of 9.6 times one's money. In the case of the 28,000 series, the leverage would be on the order of 22 times one's money.

William Fleckenstein, a Seattle money manager (and paid-up subscriber to *Grant's*, by the way), says that, after thoroughly checking the field, he bought the 28,000 series. "I give up the first 9%," he says, comparing them to the 33,000 models, but when [the Nikkei] starts rolling on the down side, I have almost three times as much leverage." The question is: "What is your premise going in?" Fleckenstein goes on. "The idea either works—and the market trades on reality—or they keep it going forever," he says. Thus, he contends that the extra year of time value isn't worth the cost. Yes, we said, but we could just have easily have been bearish in 1988, 1987 or 1986. In fact, we were. Yes, Fleckenstein replied, but the Japanese market is palpably closer to a fall than it was three years ago. Courage, he advised.

Sid Klein, a broker at Prudential-Bache Securities in Montreal, shares Fleckenstein's enthusiasm for the short side of the Japanese market and for the Salomon warrants. His preference, too, is the 28,000 strike series. Put two-thirds or three-quarters of your dry powder in those warrants and the balance in the 31,000 series. His least favorite put vehicle is a series of warrants issued last winter by Bankers Trust's Canadian subsidiary. The leverage inherent in the BT Canada series (which offers a 32,000 strike) on the same hypothetical break in the Nikkei would be less than five times the amount of one's initial investment. So far out of whack is the Canadian series, one might surmise, that some person or persons have been selling it short and buying the 33,000 Salomon series to lock in an arbitrage profit. In any case, Klein continues, the 33,000 series is not as appealing as the other two Salomon issues.

Not that any of this is risk-free. For one thing, the warrants constitute a general, unsecured obligation of Salomon Brothers. They are no better (and no worse) than the creditworthiness of the eminent bond-trading, merchant-banking institution. For another thing, Nikon Keizai Shimbun, which publishes the Nikkei index, might cease to publish it. It might publish a new, or modified index, calling it the son of Nikkei. In that case, Salomon, "in its sole discretion," might choose to adopt this successor index as the real McCoy. Thinking too long about such contingencies, one might never get out of bed in the morning. Or call one's broker.

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