GRANT'S
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Introducing the *Grant's* Story Stock Index

No bull stock market is complete before the debut of the kind of equity that's valued on the quality of its narrative. It's the anticipation of earnings, not their actual arrival, that sets the speculative heart fluttering in the late stages of a proper levitation. "The road is better than the inn," wrote the immortal Cervantes centuries before the Twitter IPO.

Now unfolding is a review of the new crop of story stocks. We write for the not-so-far-receptive members of the Federal Open Market Committee, as well as for the sainted paid-up subscribers. Nothing flatters distantly projected earnings more than an ultra-low discount rate, as Evan Lorenz, our own in-house Chartered Financial Analyst, points out. Here, then, is a story of interest rates as much as of stocks.

"One hundred dollars of earnings 10 years in the future are worth $38.55 today if discounted at 10%," CFA Lorenz reminds us. "At a 5% discount rate, they are worth $61.39. But at a zero-percent rate, they are worth $100—and would be worth that much from here to eternity." So while each of the 15 component companies in the *Grant's* Story Stock Index has its own story to tell, the unifying theme is ZIRP.

Not just any "shooter," to reclaim a term from the "great garbage market" of the 1960s, qualified for the *Grant's* index. Lorenz screened for stocks that are expensive on multiples of earnings, EBITDA (i.e., earnings before interest, taxes, depreciation and amortization), or that show no earnings but trade at high multiples of revenues. When possible, our candidates exhibit other characteristics of a good short-sale specimen, including insider selling and an adequate supply of shares to borrow (the exceptions on this latter score are Zillow and ChannelAdvisor). All but one of the names is a member of the Russell 2000, the exception being Sprouts Farmers Market, which we deal with elsewhere in this issue. Let's have a look at what the bull dragged in.

Tile Shop Holdings (TTS on the Nasdaq), our first exhibit, ticks the most critical story-stock box: It's valued not on what has happened but what may come to pass in the far reaches of the future. Founded in 1985 by the incumbent CEO, Robert A. Rucker, Tile Shop went public only in 2012. The company operates 83 stores that average more than 22,000 square feet. It operates them in 28 states, mainly in the Midwest and Mid-Atlantic regions, in which it sells tiles, both stone and ceramic, as well as setting and maintenance products. It buys straight from manufacturers; 58% of its tile comes from Asia.

Chinese quality control not being all that it might be, the heavy reliance on Asia raises concerns about product integrity. Indeed, Rucker conceded on the Oct. 30 earnings call, that some of the company's merchandise "may contain trace amounts of inorganic metals." He said that, to nip a potential problem in the bud, URS Corp. has been retained to investigate the company's supply chain.

"It's OK to invest again. The market's up."

Quoted at 48 times the 2013 earnings estimate, Tile Shop would like the world to know that it means to grow to 140 to 150 stores in the "near term" and to more than 400 stores in the "long term."

And the world's a believer, to judge by the track of the share price. Home Depot and Lowe's Cos., which also carry tile products, change hands at an average of 21.8 times their 2013 estimates. Has Mr. Market, under the influence of Mr. Bernanke, perhaps gotten a little ahead of himself? As it is, Tile Shop trades at a $1.1 billion equity market cap. Let us assume that it achieves its near-term goal of 145 or so stores. And let us further assume that, having built them, the company watches its earnings multiple contract to match the more mature valuations of Home Depot and Lowe's (the road is better than the inn, after all). In that case, if one applied Tile Shop's current tax rate and margins, a $1.1 billion equity market cap would be in order. In other words, you could argue, Tile Shop is already valued as if it has done what its CEO has only promised it will do.

If Tile Shop commands a much higher valuation than its mega-box, do-it-yourself comps, a bull might interject, it's because Tile Shop earns so much higher margins than they do. In fact, the would-be national tile superstore chain reported a 27.7% EBITDA margin in 2012, more than double those of Home Depot and Lowe's.

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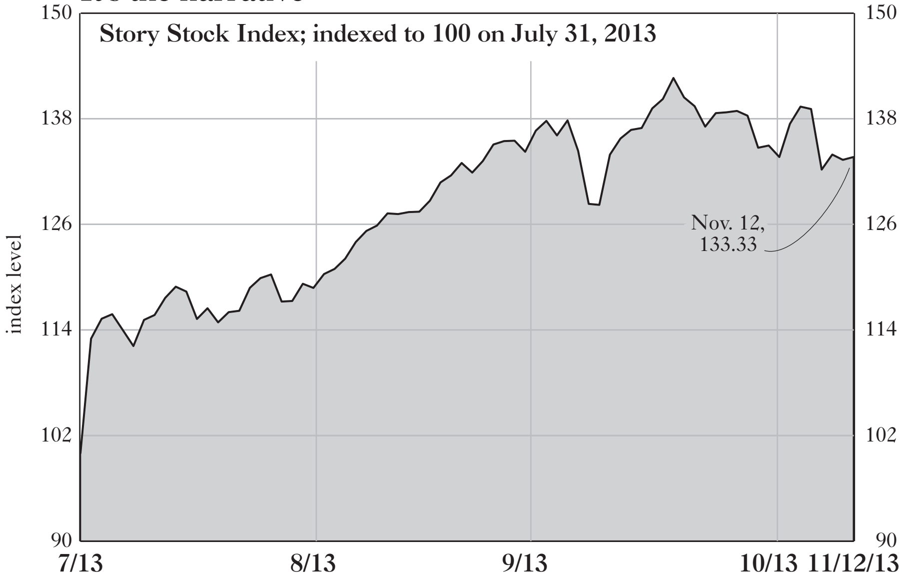
It's the narrative



source: The Bloomberg

One might suppose that the cost of being a public company would whittle Tile Shop's EBITDA margin, say by two or three percentage points; the law of diminishing returns may prove another source of margin compression. The store count grew to 53 from 42 in the three years through 2011. It jumped 28%, to 68, in 2012, and it's expected to rise by an additional 29%, to 88, in 2013.

In years past, says the front office, a new store would generate sales of $1.9 million in Year 1, whereas recent openings produced revenues of $1.8 million in the first 12 months of operation. Not that that fact is cause for concern, CFO Timothy C. Clayton assured dialers-in on the third-quarter earnings call. "[T]he performance of our stores in subsequent years is growing at a faster rate than previously discussed," said Clayton. "We now find that, on average, our new stores grow at a 22% to 23% rate the second year, 12% to 14% the third year, at 7% to 9% in the fourth year." How Clayton can be so sure of years three and four, we don't know; Tile Shop's recent growth spurt only started two years ago.

That it's no easy thing to manage an expansion like the one Tile Shop envisions is obvious on its face. But for any who doubt it, consider management's about-face on advertising outlays. A note in the 2012 10-K report boasts: "Unlike many of our competitors, we do not rely on significant traditional advertising expenditures to drive our net sales. We establish and maintain our credibility primarily through the strength of our products. . . ."

Compare and contrast Rucker's remarks on the Oct. 30 call: "Right now, we're testing television advertising in a few select markets to replicate a national advertising budget." All in all, we are going to venture that not since the great mosaics of the churches of Constantinople has anything having to do with tile been so richly valued as Tile Shop is in the zero-percent Bernanke stock market.

Health is the narrative of our second Story Stock Index component company. Boulder Brands (BDBD on the Nasdaq) is the top maker of gluten-free foods in North America and a leading maker of buttery-like spreads without trans fat. Udi's and Glutino and Earth Balance and Smart Balance are among its brands. Its customers may be vegan, or gluten-intolerant, or trans-fat averse, or just fashionable. Whoever they are, management is betting there'll be more of them, and the stock market seems to agree. The shares are valued at 50 times forecast 2013 earnings.

"The bull case for Boulder is that the gluten-free diet is going mainstream," Lorenz relates. "A certain number of Americans suffer from celiac disease, a disorder in which eating gluten—found in wheat, barley and rye—triggers an immune reaction. The National Foundation for Celiac Awareness puts the figure at three million, and it reckons that another 18 million may be gluten-sensitive. Boulder Brands estimates the combined ranks of celiacs and the gluten-sensitive at 43 million. It does Boulder no harm that the No. 2-ranked male tennis player, Novak Djokovic, ascribes his professional surge to a gluten-free diet.

"I have a number of relatives who are gluten-sensitive," Lorenz continues. "While gluten-free is rapidly expanding from a low base, there are many reasons to doubt it will catch on with the mainstream like the Atkins diet in the 2000s, the low-fat diet in the 1990s, or even bran muffins in the 1980s. Reason No. 1, gluten-free bread lacks the taste and texture of bread made from wheat—if you have to eat it, be sure to toast it and slather it with cheese. No. 2, gluten-free recipes are typically higher in calories than ordinary ones. No. 3, gluten-free is more expensive."

As for Boulder, you wonder about the quality of its revenue growth. In the third quarter, it achieved a 17% bump in sales with a 40.4% leap in accounts receivable. It was the ninth consecutive quarter in which growth in receivables outpaced growth in revenues.

One wonders, too, about the Smart Balance division. In the third quarter, it chipped in 35% of sales and 46% of earnings, and it did so on the back of declining revenues—down by 4.4% after adjusting for discontinued product lines. Nor will competition likely be less intense after the scheduled April 7, 2015, expiration of the patents that protect the Smart Balance approach to heart-healthy spread manufacture.

Boulder Brands grew out of Smart Balance, but that core business alone could never have landed the company in the kicky *Grant's* Story Stock Index. Failed attempts to "leverage" the Smart Balance brand, in fact, led to a $130 million write-down in 2010. Source of the current corporate sparkle is rather the gluten-free business. It contributes the lion's share of the 65% of revenue and 54% of profit that Smart Balance brands did not provide in the three months to Sept. 30.

How does the gluten-free business look from outside the corporate walls of Boulder Brands? To the CEO of Annie's Inc., John M. Foraker, who spoke at the Barclays Back to School Consumer Conference on Sept. 4, it seems to look a little faddish.

"Those [gluten-free] items are doing exceptionally well," said Foraker. "They've been growing much faster than the total business for quite some time, but we are also cognizant that some consumers are in gluten-free maybe for diet reasons and other things, which may be not as sustainable. So we want to make sure that we have products that taste great. So that's limited what we've done there in terms of SKU proliferation."

Net of cash, Boulder Brands shows debt of $242.1 million, or 3.9 times trailing 12-month EBITDA. Over the past 12 months, operating income covered interest expense by 2.4:1. Debt is a fad, too.

A "storied story stock"—that's Lorenz talking—is our specimen No. 3, Opko Health (OPK on the Big Board). Founded in 1991 as Cytoclonal Pharmaceuticals and known at other times as eXegenics, Opko has apparently never generated net income. It has tried but failed to produce cures for cancer, infectious diseases and macular degeneration. Still at it, the company is today trying to diagnose prostate cancer, to produce a long-lasting human growth hormone and to cure nausea related to chemotherapy. It owns a portfolio of miscellaneous businesses distributing and/or manufacturing veterinary and pharmaceutical products in Mexico, Spain and Israel.

Bulls are rooting hard for the success of an Opko test for prostate cancer; a clinical trial of the device, called 4Kscore, is slated for the first quarter of next year. A lingering cloud over the test is a critical editorial that appeared in the May 2010 edition of "Clinical Oncology." "In this report," said the editors of an article detailing the performance of the Opko product, "24% of all cancers and 14% of high-grade cancers would be missed . . . it seems that a change in screening practices that misses any high-grade cancer cannot be considered an improvement over standard screening." In other words, it would seem, here is a cancer test that misses cancer.

What remedial action, if any, Opko has subsequently taken to address the concerns of its critics, we don't know. Some, the bulls must expect. An estimate by Jefferies & Co. ascribes $4 out of the $10 share price to the value of the 4Kscore test. On a hopeful note, the company launched the product in the U.K.; it did so in October 2012. On a somewhat less hopeful note, no trace of any 4Kscore-derived revenue is to be found in the company's subsequent financial filings.

To be clear, we do not insist that Opko will not succeed in one or more of its myriad undertakings; a new growth hormone is said to look promising. All we are saying is that this particular lottery ticket, valued at 42 times estimated 2013 revenues, says as much about the stock market as it does about the present value of any reasonably likely future cash flows that Opko might one day actually generate.

Reviewing the flyaway stock market of 1968-69—that "great garbage market"—the author John Brooks, in his history, "The Go-Go Years," had this to say about stocks like the ones in the new *Grant's* index:

"[W]hat a promoter needed to launch a new stock, apart from a persuasive tongue and a resourceful accountant, was to have a 'story'—an easily grasped concept, preferably related to some current national fad or preoccupation, that *sounded* as if it would lead to profits."

Tiles may not yet be a national preoccupation, and the top of this particular stock market may not yet be in sight. So be it. At *Grant's*, the watchword is vigilance.

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Okay to inhale

In health-conscious America, there are fewer and fewer smokers. And on tapering-fretful Wall Street, there are fewer and fewer bond bulls. These facts being understood, we write to extol the speculative merits of certain tax-exempt securities backed by cigarette sales and protected from inflation. Complex and controversial, tobacco bonds are high-yielding for a reason.

In 1998, the four big tobacco companies, on the one hand, and 46 states, the District of Columbia and U.S. territories, on the other, entered into an agreement to settle the outstanding litigation between them. Philip Morris, R.J. Reynolds, Lorillard and Brown & Williamson comprised the big four, a.k.a., the "original participating manufacturers." Since the settlement, another 40 manufacturers have signed on—call them, as the lawyers do, the "subsequent participating manufacturers."

The "master settlement agreement," or MSA, is the name stamped on this détente. It directs the companies to pay $9 billion a year, before applying a variety of adjustments, into a trust to compensate the plaintiff governments for the costs with which cigarette smoking has burdened them. Over the past 12 years, 22 states and some municipalities have issued securitized claims on anticipated MSA-derived revenue; $34 billion worth at face amount are outstanding.

Though states issue tobacco bonds, the credit of those states has nothing to do with the quality of the securities. Cigarette sales, rather, furnish the cash flows (it would therefore be a good thing if the currently solvent and profitable big cigarette makers remained that way). The wrinkle is how those sales—and, thus, required payments into the MSA-related trusts—are totted up.

Story Stock Index
(in $ millions)

					EV/est.	
name	**ticker**	**mkt. cap.**	**short int. float**	**price to est. 2013 earn.**	**2013 sales**	**2013 EBITDA**
Demandware	DWRE	$1,888	5.2%	—x	17.6x	—x
ChannelAdvisor	ECOM	841	6.7	—	13.9	—
Tile Shop Holdings	TTS	1,072	15.0	47.7	4.9	19.8
Opko Health	OPK	4,081	16.2	—	42.4	—
Boulder Brands	BDBD	917	13.4	49.8	2.5	15.4
Sprouts Farmers Market	SFM	7,058	3.4	101.8	3.1	39.2
Infoblox*	BLOX	2,274	3.9	80.5	8.0	50.9
8x8 Inc.*	EGHT	720	5.7	49.2	5.2	37.3
Constant Contact	CTCT	858	8.7	38.6	2.6	16.4
Mobile Mini Inc	MINI	1,785	4.1	33.6	5.8	15.2
Cornerstone OnDemand	CSOD	2,449	5.7	—	13.1	2125.3
Shutterstock	SSTK	2,569	11.9	87.8	10.5	49.1
Textura*	TXTR	709	18.7	—	18.4	—
Yelp	YELP	4,578	12.1	350.2	19.5	155.1
Zillow	Z	3,056	22.1	5188.0	14.8	121.4

*non-financial years

source: The Bloomberg

It's not as simple as just writing checks. The $9 billion annual base payment is adjusted for inflation, tobacco consumption and the tobacco companies' success (or lack thereof) in retaining market share, among other factors. Further complicating the situation is slow-drip litigation between the states and the manufacturers, as well as the advent of electronic cigarettes. There are two good reasons to try to penetrate the legalistic fog: the high proffered yields and the formidable inflation armor.

In 1998, 3% seemed a reasonable expectation for the annual minimum rate of increase in the CPI-U; accordingly, payments due from the manufacturers are slated to rise by the greater of 3% or the inflation rate in the year preceding the payment date. One may think of this as low-cost protection against the 21^{st}-century paper dollar going up in smoke.

In 1998, tobacco consumption had already been falling for 17 years. In calculating the payment formula, the parties negotiated what they judged to be a reasonable allowance for continuing declines in cigarette smoking. The question is whether they were conservative enough. The formula for adjusting the cash flows to the MSA is not so interesting. More relevant—and for the would-be investor, more sobering—is the accelerating rate of decline in tobacco consumption. A "base volume" of cigarette shipments was written into the law in 1998; it was 475.7 billion cigarettes per annum. A measure of the success of the national anti-smoking juggernaut is that, in 2012, shipments totaled only 290 billion. And now come e-cigarettes.

Tobacco bonds have been issued in a variety of structures and maturities. Typically, revenue is apportioned to different classes of securities in hierarchical, or waterfall, fashion. First claim is interest on all the coupon bonds, senior and subordinated. Available cash is next apportioned to redeeming the serial, or bullet, maturities. Remaining funds go to redeeming the so-called turbo bonds in the order of their maturity. Last in the queue for dollars are the zero-coupon bonds, a.k.a., capital-appreciation bonds; they get nothing until all senior maturities are repaid. California, New Jersey, Virginia, Michigan and Ohio are among the foremost issuers of CABs.

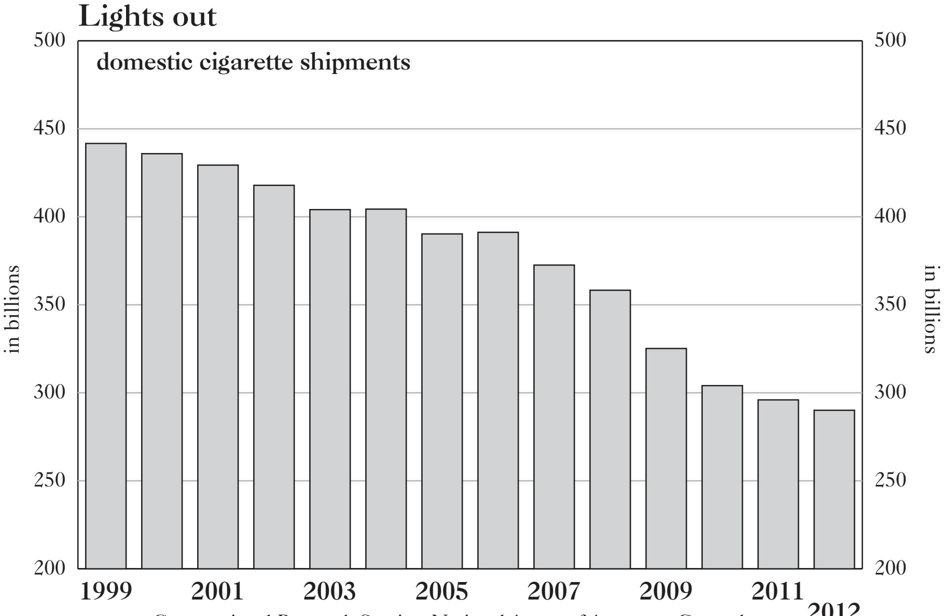
Ohio's 2007-vintage Buckeye Tobacco Settlement Financing Authority bonds make a good illustrative case. The issue comprises $211 million in senior bonds ($72 million of which have already been redeemed), $5 billion in turbo bonds ($130 million of which have been redeemed) and $319 million, face amount, of zeroes. The senior revenue bond due 2017, which carries an investment-grade rating from three agencies and is exempt from federal taxes (and from state taxes for Ohio residents), trades at 106.35 to yield 3.09%. At the other end of the credit spectrum, the Buckeye zeroes of 2047, which Fitch rates single-B-minus, are quoted at 3.2 to yield 10.7%—they came to market at 5.94 to yield 7.25%.

"Date of issuance matters for credit quality," colleague Charley Grant observes. "In general, securities that came into the world in the early part of the decade are likely to pay off by maturity or sooner, whereas issues from 2006 to 2008 were structured with a lower margin of safety. Examples of the latter, higher-risk vintage include the 2006 New York City TSASC 5s of 2026, quoted at 82.98 to yield 7.07%; the Golden State Tobacco Securitization Corp. 5s of 2033, quoted at 74.87 to yield 7.46%, and the Buckeye 5 1/8s of 2024, quoted at 83.66 to yield 7.4%. Examples of safer and saner bonds—ones that could withstand a much steeper plunge in tobacco consumption—include the Illinois Railsplitter 6s of 2028, quoted at 109.32 to yield 4.55%, or the Arkansas Development Finance Authority 5 1/4s of 2041, quoted at par."

Could smoking go the way of dueling, medicinal bleeding or bearbaiting? Governments the world over seem determined to snuff it out. Thirty states, the District of Columbia and Puerto Rico have banned smoking from the workplace, including restaurants and bars. The New York City Council just voted to raise the minimum age for buying cigarettes to 21. The mayor of Chicago, Rahm Emanuel, is proposing to lift the city's $3.68 per-pack excise tax by 75 cents. As it is, a pack of Marlboros in the south Loop will set you back $11.95. In lower Manhattan, the price is $12.71. Loosies—cigarettes sold illegally one by one—fetch between a quarter and a dollar each. And now the Web site of Americans for Nonsmokers' Rights is on the rampage about a heretofore unknown menace it calls "thirdhand" smoke, e.g., the kind you smell on the sweater you wore to the party the night before. Since the MSA went into effect in 1998, cigarette shipments have declined at a compound annual rate of 3.18%. In 2009 and 2010, respectively, they plunged by 9.2% and 6.5%.

Nor does this exhaust the list of reasons a risk-intolerant investor might choose to steer clear. The tobacco companies do not passively remit funds to the MSA but pay lawyers good money to find reasons not to remit them. For instance, the basic agreement protects participating cigarette manufacturers against competitive inroads made by producers who operate outside the MSA. By law, the latter must remit escrow payments in the approximate sums required of MSA participants. Whether

Lights out



sources: Congressional Research Service, National Assoc. of Attorneys General

A pack of tobacco bonds
(in $ millions)

issuer	coupon	mat. date	issue date	par out.	rating	tax-ex	price	yield
Railsplitter Tobacco Settlement (Ill.)	6.00%	2028	2010	361	A-/BBB+	federal	$109.32	4.55%
TSASC (NY)	5.00	2026	2006	138	B+/BB-	fed/state	82.98	7.07
Buckeye Tobacco Settlement (Ohio)	5.13	2024	2007	842	B3/B-/B-	fed/state	83.66	7.40
Golden State Tobacco Securitization (Cal.)	5.00	2033	2007	611	B3/B-/B	fed/state	74.87	7.46
Tobacco Settlement Financing (R.I.)	6.25	2042	2002	372	Ba1/BB/BBB-	fed/state	92.37	6.87
Arkansas Development Finance	5.25	2041	2001	8.3	A1	fed/state	100.16	5.24
Niagara County Tobacco Asset Securitization	6.25	2040	2001	15	Baa3/BBB+	fed/state	88.29	7.30

source: The Bloomberg

or not such funds are duly paid in—it's the states' responsibility to collect them—is a matter of controversy. If an arbitrator finds that a state's failure to enforce the law has caused economic loss to a participating manufacturer, that manufacturer is entitled to recoup some or all of its payments to the MSA; about $2.5 billion remains in escrow for disputed payments.

"Some idea about the pace of conflict resolution is suggested by the fact that an arbitration panel's ruling about $1.1 billion in disputed 2003 MSA payments was handed down 10 years later—just two months ago, in fact," Grant relates. "It happens that New York, Ohio, Illinois and Iowa, all with tobacco bonds outstanding, were among the winners. But a half-dozen states lost at arbitration, though none is a tobacco-bond issuer. Richard Larkin, director of credit analysis at the Fairfield, Conn., bond house of H.J. Sims, contends that—based on continued 4% per annum declines in tobacco consumption, and inflation remaining below 3% per annum—several tobacco-bond issuers will suffer at least partial defaults.

"It certainly didn't help that the bankruptcy of Lehman Brothers resulted in the voiding of the state's guaranteed investment contracts," Grant goes on. "When these contracts and their mid-single digit yields evaporated, MSA payments had to be invested at post-Lehman money market rates. Ohio, along with Virginia and California, was forced to draw down cash reserves to make an interest payment. Which explains why when you punch up the Buckeye 5 1/8s on a Bloomberg terminal, the machine answers with a red flashing message on the description page saying, 'Distressed.'"

What might cause the light to stop flashing? A bout of inflation could do the trick. The mandated inflation adjustment—the greater of 3% or the year-over-year rise in the CPI-U—is that most prized feature among value-seeking investors, namely, the free, or low-price, option. In this case, it's an option on the inflation-seeking economists featured in a *New York Times* story of a couple of weeks ago finally getting their wish (*Grant's*, Nov. 1).

Another bullish possibility concerns the aforementioned tussle over that $2.5 billion escrow fund. To the holders of a "leveraged" tobacco security—that is, a bond that will be hard-pressed to redeem on time if the falloff in cigarette smoking accelerates much beyond the 3.5% or 4% rates seen so far—receipt of a few hundred million dollars in a legal settlement can spell relief. Ohio's victory in the September arbitration ruling, which will boost the state's 2014 MSA receipts by 11.9%, gave a 15-point lift to the Buckeye 5 7/8s of 2047. Before the news, the bonds changed hands at 62.61 to yield 9.6%; today, they trade at 77.62 to yield 7.7%. Another arbitration victory, this one for New York State, produced an even bigger rally in New York City's TSASC 5 1/8s.

Then, too, cigarette smoking may or may not decline by 4% a year until nobody smokes and everybody runs marathons and eats bean sprouts. "Maybe smoking a cigarette will seem less risky in the future than it does today, either through advances in manufacturing or medicine," Grant speculates. "Or maybe declines in cigarette consumption will level off at a rate lower than 4%."

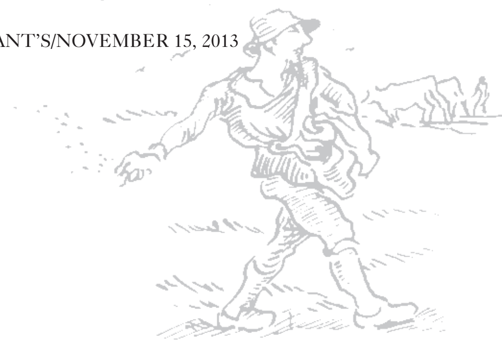
On this score, bulls can point to the history of American drinking. So astoundingly high was whiskey consumption in the early Republic that you wonder how the pioneers found the Allegheny mountains, let alone crossed them. In 1851, Maine passed a prohibition law, and by 1855 a dozen states had followed suit. There was a second, better-remembered experiment with national prohibition between 1920 and 1933. Per-capita alcohol consumption fell over the course of the centuries, but it never went away. Maybe cigarettes will have the same persistence as the dry martini.

As a threat to tobacco bonds, the electronic cigarette, too, may be overrated. E-cigarettes emit water vapor instead of smoke and do not contain tar or objectionable additives. One doesn't smoke them, one "vapes" them, and some analysts project that vaping could eclipse smoking worldwide by 2040.

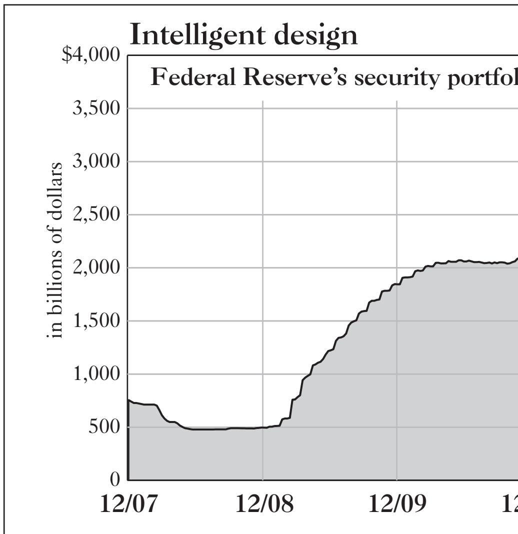
E-cigarettes are not—yet—part of the MSA proceedings, but it's not so farfetched to imagine that state attorney generals will press the argument that they deserve to be, especially since Lorillard, a card-carrying member of Big Tobacco, acquired Blu Ecigs last year for $135 million. The text of the MSA defines "cigarette," in part, as "any product that contains nicotine, is intended to be burned or heated under ordinary conditions of use, and consists of or contains any roll of tobacco wrapped in paper or in any substance not containing tobacco. . . ." It sounds to us not a little like an e-cigarette.

But what if worse comes to worse and your Buckeye 5 1/8s of 2024 do default? Let us say, advises a paid-up subscriber who owns the bonds (and asks to go unnamed), that the 2024 maturity date comes and goes without you having been repaid. And let us say that $100 million of the original $400 million remains outstanding. In that case, our informant notes, "you get a 5 1/8% coupon on that remaining $100 million. In the situation where consumption declines are draconian, you basically get that in perpetuity. . . . You're getting a full coupon plus debt repayment off of an $85 price, and then you have this really long tail, which, in

(Continued on page 8)



CREDIT CREATION



FEDERAL RESERVE BALANCE SHEET
(in millions of dollars)

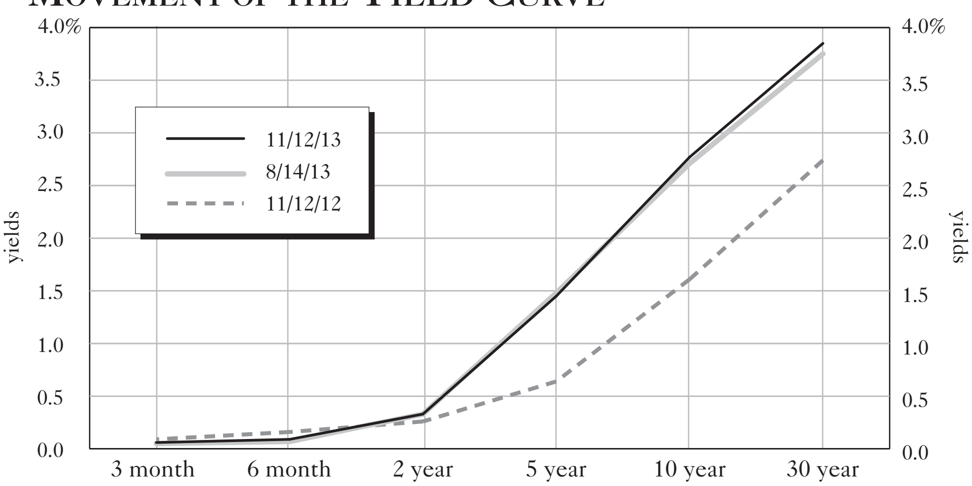
	Nov. 6, 2013	Oct. 30, 2013	Nov. 7, 2012
The Fed buys and sells securities…			
Securities held outright	$3,573,291	$3,566,391	$2,583,852
Held under repurchase agreements	0	0	0
and lends…			
Borrowings—net	189	233	1,171
and expands or contracts its other assets…			
Maiden Lane, float and other assets	229,425	228,696	198,751
The grand total of all its assets is:			
FEDERAL RESERVE BANK CREDIT	$3,802,905	$3,795,320	$2,783,774
Foreign central banks also buy, or monetize, governments:			
Foreign central bank holdings of Treasurys and agencies	$3,331,989	$3,316,184	$3,193,629

BANK OF ENGLAND BALANCE SHEET*
(in millions of pounds)

	Nov. 6, 2013	Oct. 9, 2013	Nov. 7, 2012
Loans	£ 525	£ 585	£ 11,655
Securities	17,198	16,996	13,508
Other assets	386,617	385,665	389,309
Total assets	404,340	403,246	414,472

*totals may not add due to rounding

MOVEMENT OF THE YIELD CURVE



source: The Bloomberg

Deficits in se

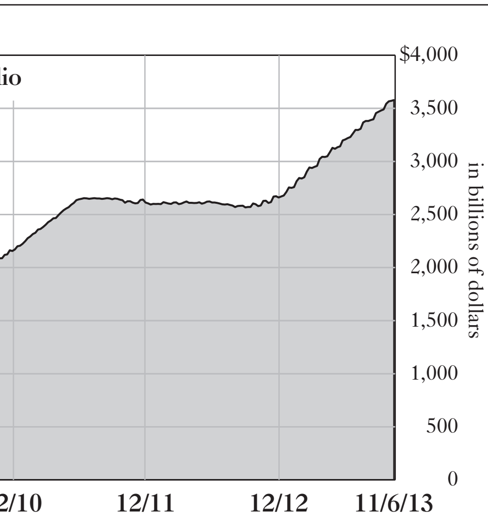
"[I]t is hard to imagine a world where the main currency is based on an extremely complex code understood by only a few and controlled by even fewer, without accountability, arbitration, or recourse." No it isn't. It's the world we live in.

The author of the quoted remarks, Chicago Fed senior economist François R. Velde, was writing about Bitcoin (he published in the December issue of the Chicago Fed Letter). He might have had the dollar in mind. "Extremely complex?" Try to parse the Fed's Dynamic Stochastic General Equilibrium model (*Grant's*, Oct. 5, 2012). "Without accountability, arbitration, or recourse?" The Federal Open Market Committee to a T.

"A flawed DSGE model missed the biggest credit bubble in a generation," colleague Evan Lorenz observes. "A flawed CPI index might be missing a rise in prices today. Note, for example, as the perceptive David Rosenberg, chief economist at Gluskin, Sheff & Associates, already does, the disparity between market-based price measures, on the one hand, and CPI-measured price measures, on the other.

"Thus," Lorenz proceeds, "home prices are rising at a 12.8% year-over-year rate, according to the S&P Case-Shiller Index, while owners' equivalent rent is up by only 2.2% in the CPI. Airline ticket prices have risen by 5.5%, year-over-year, according to the International Air Transport Association, but by

• Cause & Effect



elf-awareness

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Annualized Rates of Growth
(latest data, weekly or monthly, in percent)

	3 months	6 months	12 months
Federal Reserve Bank credit	34.8%	34.6%	35.7%
Foreign central bank holdings of gov'ts.	6.2	0.9	3.8
Bank of England	-1.0	-0.1	-2.0
Commercial and industrial loans (Sept.)	4.8	6.0	8.2
Commercial bank credit (Sept.)	-2.1	0.0	1.8
Primary dealer repurchase agreements	-24.2	-7.8	-6.6
Asset-backed commercial paper	-25.3	-20.4	-10.5
Currency	7.2	6.3	7.0
M-1	14.5	9.1	8.9
M-2	9.6	8.3	7.0
Money zero maturity	10.4	8.8	7.5

Reflation/Deflation Watch

	Latest week	Prior week	Year ago
FTSE Xinhua 600 Banks Index	8,852.34	9,152.88	7,595.80
Moody's Industrial Metals Index	1,829.70	1,849.24	1,871.82
Silver	$21.32	$21.84	$32.24
Oil	$94.60	$94.61	$85.09
Soybeans	$12.96	$12.52	$14.96
Rogers Int'l Commodity Index	3,445.31	3,517.54	3,627.31
Gold (London p.m. fix)	$1,285.50	$1,306.75	$1,717.00
CRB raw industrial spot index	522.02	514.98	505.22
ECRI Future Inflation Gauge	(Oct.) 99.5	(Sept.)100.1	(Oct.) 104.2
Factory capacity utilization rate	(Sept.) 78.3	(Aug.) 77.9	(Sept.) 77.2
CUSIP requests	(Oct.) 1,687	(Sept.) 1,635	(Oct.) 1,717

Effectiveness of Monetary Policy

	Sept. 2013	Sept. 2008	Sept. 2003
Monetary base ($ billions)	$3,486.9	$909.7	$721.1
M-2 ($ billions)	10,818.5	7,833.7	6,044.7
Money multiplier (M-2 / monetary base)	3.10	8.61	8.38
Velocity of money (GDP / M-2)	1.54	1.89	1.92

(Continued from page 5)

some instances, isn't that bad. That's a benefit of the structure. In 2024, it's not like payments stop and you go into a bankruptcy, and you have to hire lawyers and do a workout [the tobacco bond structures do not allow bankruptcy]. It's not like we want a default. We don't. But if they do, we can live with it."

Of course, just how one equably could live with default would depend. If interest rates were as low as they are today, one might be delighted: a 5.125% tax-exempt coupon in perpetuity would be no bad thing. In a ferocious bond bear market, one would be less delighted. Even so, the built-in inflation protection would likely serve to remove some of the sting.

A very different situation would confront the holder of the aforementioned Buckeye zero-coupon bond of 2047 in the event that smoking stopped. Funds being unavailable to redeem his securities in 2047, he would just have to wait. The longer he waited, the lower his internal rate of return would be. The zeroes came to market in the fall of 2007 and traded right around the issue price (between five and six cents on the dollar) until 2009. In March of that eventful year, they fetched just 1.5 cents on the dollar. Now they're quoted at the aforementioned 3.2 cents on the dollar.

For *Grant's* readers who prefer a less risky fixed-income investment, turbo bonds issued by the Niagara County, N.Y., Tobacco Asset Securitization Corp. may be worth a look. The 6 1/4s of 2040, callable at par, changed hands last week at 88.29 to yield a federal and state tax-exempt 7.3%, a taxable equivalent of 12.7% for New Yorkers in the top tax bracket. Just under $15 million face value is outstanding. Moody's, which rates the bond Baa3, projected a breakeven annual rate of decline in cigarette consumption of 5.8% in July 2012 (assuming that inflation does not exceed 3%). This cushion is considerably fatter than the 2% to 3% annual decline that, in the agency's opinion, Ohio and California turbos can withstand. The highest quality bonds can bear up under a 25% annual decline or greater in consumption—with uninvitingly low yields to match.

"Bonds require complicated proprietary cash-flow modeling," a Citigroup primer on tobacco securities warns—"there are no common analytics packages." To be sure, this is a complicated business. Were it otherwise, probably the opportunity would be less attractive.

Please know that the staff of *Grant's* has performed no such proprietary modeling. Having consulted many who have, we conclude that the tobacco bonds are a worthy speculation. Widows and orphans may choose to stand clear—the latter shouldn't be smoking anyway.

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All you can eat

"Yes, food retailing is more competitive than ever," John Mackey, co-founder and co-CEO of Whole Foods Market, said during the conference call last week that followed release of satisfactory fiscal 2013 results (but of worrying 2014 guidance). "And with the growing demand for fresh, healthy foods, it seems like everyone is adding to or expanding their offering of natural and organic products."

Enter here, Sprouts Farmers Market (SFM on the Nasdaq), the multiple-sprouting specialty retailer of natural and organic food and charter member of the *Grant's* Story Stock Index. Today, there are 167 Sprouts stores. Over the next two decades, if all goes according to plan, there will be 1,200. Nodding his assent, Mr. Market has assigned the stock an 80 multiple on the 2014 sell-side earnings estimate and an equity capitalization of $7.1 billion. *Grant's* is bearish on it.

The Sprouts family tree looks like something out of the Book of Genesis. The company is the product of a succession of mergers. It's relevant for this analysis that, in 2007, Whole Foods purchased Wild Oats and sold Henry's Farmers Market (then a part of Wild Oats) to Apollo Management. In April 2011, Sprouts, which now had 63 stores, entered into a transaction with Apollo, and the private equity firm created the subject of this essay by combining Sprouts with Henry's. "Reading the company's prospectus," relates colleague David Peligal, "you're hard-pressed to truly understand the historical financials since three companies—Sprouts, Henry's and Sunflower Farmers Market—were rolled up and put together. Everything is pro-forma."

Anyway, Sprouts, which is based in Phoenix and operates in the $600 billion American supermarket industry, is eating the lunch of conventional food retailers. "According to the *Nutrition Business Journal*," the company's prospectus reads, "spending on natural and organic food experienced a compound annual growth rate of 12% from 1997 to 2011, reaching $43 billion in the United States [revisions raise that figure to $45.5 billion], and is expected to continue to grow at a CAGR of 10% through 2020."

Doug Sanders, Sprouts' president and CEO, brought the gospel of growth to a Goldman Sachs-sponsored September investor conference. "If you think about where growth is in retail grocery," said he, "traditional grocery is growing with inflation, 2%, 2.5%. Natural and organic sector is growing at 10% plus, and this is where the growth is. And the health and wellness trend, as it is gaining traction across the country, is driving that growth."

One could almost say that if Sprouts didn't exist, Wall Street would have to invent it. "Just look at the form 8-K that went along with the Goldman presentation," Peligal notes. "Why is the company a compelling investment? (A) Authentic natural and organic food offering at great value—check; (B) Fast-growing segment of the U.S. supermarket industry with strong macro tailwinds—check; (C) Significant new store growth opportunity supported by broad demographic appeal—check; (D) Proven and replicable store model with compelling unit economics—check. As to the last point, bulls contend, the Sprouts concept is unique; you don't need huge, conventional grocers' volumes to succeed. A good store is a $15 million revenue store; it's profitable. And it's cheap to build: you can put up 25,000 square feet for a net cash investment of $2.8 million. Pre-tax, cash-on-cash returns duly follow—Sprouts targets 35% to 40% within four years. Expect growth to 300 stores in existing markets, expansion within the southeastern United States by the middle of 2014, management says."

Not that Sprouts has the fresh and healthy field to itself (we wonder about opportunities in the stale and unhealthy field). Grocers big and small are homing in on it. Thus, Cincinnati-based Kroger Co. (KR on the Big Board), with its $21.8 billion market cap and resurgent share price, owns the Fry's brand in Arizona and the King Soopers brand in Colorado; both play to the Sprouts customer. Publix Super Markets, Safeway, Trader Joe's, Whole Foods, Fresh Market, Wal-Mart Stores, WinCo Foods, Natural Grocers by Vitamin Cottage, AmazonFresh etc., have their eye on the same health-conscious shopper.

It's perhaps a sign of the supercharged times that Chris Sherrell, former CEO of Sunflower Farmers Market, chose to found Fresh Thyme Farmers Market last year rather than go to work for Sprouts. Why settle for a salary when Mr. Market pays so much better?

"To get a better feel for the competitive landscape, I visited some grocery stores this week in Phoenix and Scottsdale," Peligal reports. "First stop was the Sprouts store on E. Indian School Road in Phoenix. It's situated in a shopping center with an Edward Jones office, a Papa John's Pizza and an Edible Arrangements store. I asked a woman outside why she came to this Sprouts and not Trader Joe's or Whole Foods. Carrying a small bag full of groceries, she remarked, 'I actually go to all three. It just so happens my chiropractor is located in this shopping center.' Two guys in the parking lot mentioned they came to this store for 'reasonably priced produce.' There were maybe 30 or 40 people inside the Sprouts store at around 2:15 p.m. One of the employees told me the store looks nicer now; this particular one got remodeled about six months ago. Sitting at the delicatessen counter chomping on a turkey sandwich with avocado ($2.99 plus 50 cents for the avocado), I watched people casually check out some of the bulk goods. For example: bulgur wheat for $0.99/pound, dried cranberries for $4.99/pound, and walnuts for $8.99/pound.

"Next, I stopped by a shopping center on 20th Street and Camelback Rd. in the Biltmore area of Phoenix," Peligal's dispatch continues. "It was less than a five-minute drive from my first stop. No Sprouts here. But there is a Trader Joe's and a brand-new Whole Foods, gleaming and well-stocked, complete with a juice bar, an espresso bar and another kind of bar with more than 36 craft beers on tap. I asked an ordinary Sprouts employee about the competitive situation. 'Our competition is Trader Joe's,' came the reply. 'The Whole Foods customer is the Whole Foods customer. That customer is going to Whole Foods and they're not going anywhere else. The Sprouts customer? The Sprouts customer goes to Fry's, they go to Fresh & Easy, that's our customer. We consider ourselves a transitional store, in that we appeal to the customers who would probably never go to a Whole Foods because they would never pay that kind of price.' Perhaps this is true, but as Whole Foods looks to combat its 'Whole Paycheck' reputation, management has promised to engage in 'more aggressive price matching against select competitors.'

"The Sprouts store on Shea Blvd. in Scottsdale, which was renovated earlier this year with new flooring and new freezers, was by far the most impressive of the ones I visited," Peligal's travelogue concludes. "Bulls will argue that many of the new stores Sprouts is building will be built with this format. More than the other Sprouts stores I visited—there were three, altogether—the Shea

Blvd. store seemed to draw well-heeled shoppers that weren't exclusively over 60 years old. But here's the problem: the competition isn't going away. Less than a mile away, there were two Fry's stores right off Highway 101—Fry's Marketplace and Fry's Signature. The Fry's Signature store, in particular, was probably three times the size of the Sprouts' store on Shea Blvd. and had an impressive selection of organic foods."

Burt P. Flickinger III, managing director of New York-based Strategic Resource Group, a supermarket consultant, kindly contributed his take on Sprouts, as follows: "Phoenix is by far their best market. There is quite a variance between the stores my team and I checked in California, relative to Phoenix. If they can do another 1,000 stores like what you see in Phoenix, this could be a spectacular success—even at these valuations. The problem is that the cap-ex to do all the stores like Phoenix—you're running at 'catch-up' cap-ex rates of 3.5% to 5% as a percentage of sales, and for the oldest acquired stores, cap-ex of up to 7% to 8%, which is unsustainable. In Phoenix, renovations and major remodels made Sprouts look like a brand-new store. It looks like the best of Whole Foods. Whereas in California, you have a sprinkling of so many acquired chain stores—Henry's under Smart & Final or Boney's in San Diego, which was bought by Henry's. They postponed capital expenditures for a significant amount of time. It's probably not cost effective for Sprouts to completely renovate those stores but, at the same time, sections of the stores look a little older and a little more tired."

One way to think about Sprouts' valuation is to try to imagine the completed corporate work. Assume, for instance, that management builds its 1,200th store and builds it tomorrow—there, that was easy. Those 1,200 stores at a net cash investment of $2.8 million per store would require $2.9 billion of additional investment. So add $2.9 billion to the $7.1 billion market cap, and the $372 million of net debt to get an enterprise value of $10.4 billion.

Next assume the company can hit the high end of its pre-tax cash-on-cash return target of 35% to 40%. This would yield a total of $1.12 million of EBITDA per store, or $1.34 billion of EBITDA for all 1,200 stores. Ignore corporate expense, for now. The company is trading—as we imagine it—at 7.8 times enterprise value divided by EBITDA ($10.4 billion of EV over $1.34 billion of EBITDA). So ends our hypothetical exercise.

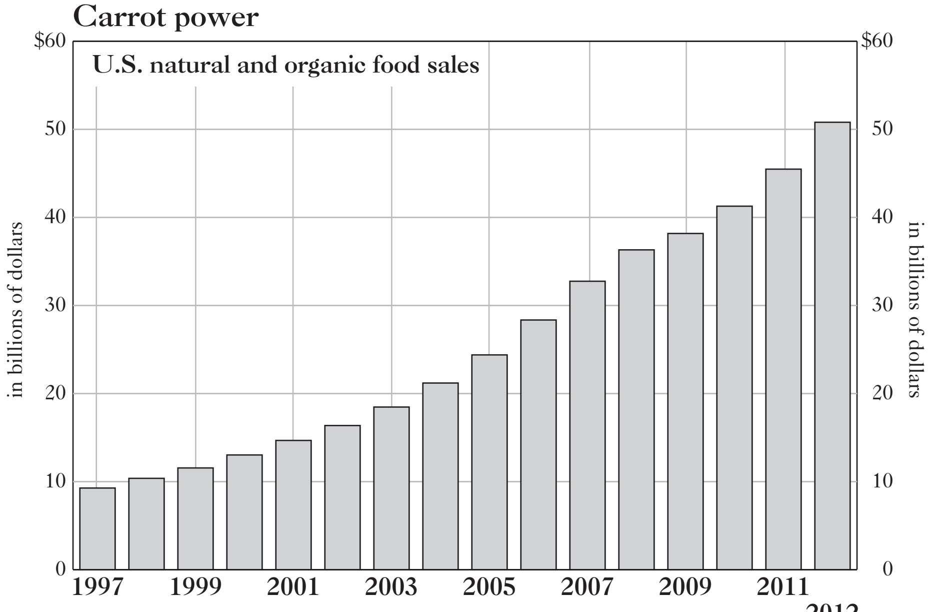
"Now then," suggests Peligal, "let's compare Sprouts as it really is to The Fresh Market (TFM on the Nasdaq), a 31-year-old specialty grocery retailer, and Fairway Group Holdings (FWM, also on the Nasdaq), a popular New York City grocer. Fresh Market, with an average store size of 20,000 square feet, operates 140 locations across 26 states. Fairway, with an average store size of about 35,000 square feet, operates 14 locations in three states. Adding the enterprise value of Fresh Market to the enterprise value of Fairway, you get $3.7 billion. It's a little less than half of the Sprouts' enterprise value. Adding the EBITDA of Fresh Market to the EBITDA of Fairway—admittedly an imprecise calculation owing to the difference in the companies' reporting periods—you get more EBITDA than Sprouts generates. In sum: for about the same sales levels and growth rates, you're getting more EBITDA with Fresh Market and Fairway and paying about half the price. One of the knocks on shorting a company like Sprouts at this point is that shorting high-growth retailers this early in the store rollout is often a loser. It's a fair criticism and perhaps this is why the opportunity exists."

In April, Leon Black, chairman and CEO of Apollo Global Management, served notice on the bull market. "We think it's a fabulous environment to be selling," he said. "We're selling everything that's not nailed down, and if it is nailed down, we're refinancing it." It should, therefore, have come as no surprise that Apollo, owner of 45% of Sprouts, filed an S-1 on Nov. 7 to sell 22.5 million Sprouts' shares, representing about 14% of the fully diluted share count or about the same number of shares as the IPO disgorged. With the stock at 45, up from an issue price of 18, Apollo has made about 10 times its original investment. Notable is that Apollo got Goldman Sachs and Credit Suisse to waive the lock-up restrictions since Sprouts only went public three months ago.

"I would watch very carefully for issuance," the short-seller James S. Chanos advised the *Grant's* Conference last month. "We're already beginning to see a lot of it. It may take a while, but I think that some of the craziness we're seeing in the Nasdaq and the Russell 2000 and some of these high-fliers is going to bring out a lot of new stock—probably within the next six to nine months, unless I miss my guess."

And, of course, Sprouts isn't nailed down.

Carrot power



source: *Nutrition Business Journal*

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'Abundance of caution'

Open before us is a letter from a Swiss bank to an American client; "Zurich, October 2013," is the dateline. The security of one's funds is the subject—and the subject of this unfolding essay, too.

"In an abundance of caution," the letter says—our informant has redacted the name of the institution—"the bank has decided that it will temporarily freeze your account to all incoming and outgoing traffic until we receive adequate documentation verifying your compliance with U.S. tax laws."

This bombshell appears at the bottom of page 2. Preceding it is the legislative and regulatory background to the action. The letter reminds its recipient that the U.S. Department of Justice and the Swiss Federal Department of Finance reached an agreement in August to unmask American tax-evaders. The bank's participation in the pact is purely voluntary, the letter says. But the Swiss authorities have "formally encouraged all eligible Swiss banks to participate."

This was all the encouragement the bank seemed to need. By complying with the terms of the agreement, says the letter, the bank may stay on the good side of the DoJ. And what are those terms? Chiefly, to demonstrate that an American account holder is "compliant with his or her U.S. tax obligations for the applicable period, which is from 1 August 2008 to the present. . . ." Failure to do so would put the bank at risk of "considerable penalties."

"The DoJ program for Swiss banks," the letter continues, "requires the bank to provide certain information to the DoJ and the U.S. Internal Revenue Service regarding its U.S. related accounts. The bank is to provide aggregate information of its U.S. related accounts but not disclose the names of its account holders. Although the names of the account holders will not be disclosed at this time, the U.S. government has mechanisms at its disposal that would allow it eventually to obtain individual client names."

No argument there; the U.S. government certainly does have its "mechanisms." And other governments have theirs. You may have read about the controversy surrounding the German government's discovery of 1,500 artworks in a trash-filled Munich apartment. While the brouhaha concerns the ownership and origins of the works, the means by which the German authorities tracked them down is also of interest. The trail of discovery began in 2010 with what *The Wall Street Journal* calls a "routine" inspection of the possessions of an elderly man on board a train from Switzerland to Munich. "During the check," the *Journal* reports, "they found €9,000 in cash. The sum was below the €10,000 threshold that travelers are required to declare, but the discovery prompted the custom authorities to investigate [the passenger] further." Which suspicions led to the surfacing of the art trove.

"Pay your taxes" would seem to be one take-away from the Swiss bank matter. "Be careful with museum-quality art collections of dubious provenance—and don't carry large sums of cash," would appear to be the principal lesson learned from the German affair. As for the course of action indicated by a brand-new trial balloon from the International Monetary Fund, it might be as simple as, "Don't bother getting rich, because the authorities need your money."

Thus, to readers of its October *Fiscal Monitor*, the IMF proposes a one-off wealth tax to restock depleted national treasuries. "The appeal is that such a tax, if it is implemented before avoidance is possible and there is a belief that it will never be repeated, does not distort behavior (and may be seen by some as fair)," the text says.

The Robin Hood approach would be no simple thing to put over, the IMF authors concede. Then, again, they note—a little chillingly, if you ask us—that neither would "repudiating public debt or inflating it away (these, in turn, are a particular form of wealth tax—on bondholders—that also falls on nonresidents)."

Simon Mikhailovich, co-founder of Tocqueville Bullion Reserve, a soon-to-be launched private institutional vehicle for owning gold outside the financial system, advises clients and depositors to take heed. Until recently, he says, the risks of holding wealth centered on the nature of the assets themselves. It made no difference who owned them, as everyone was equal before the law. But things have changed. The American recipient of the letter from that Swiss bank is deprived of the use of his assets until he can show that he's paid his taxes; the burden of proof falls on him.

"In the old framework," Mikhailovich goes on, "cash was a risk-free asset. In the new paradigm of systemic risks, no asset (even cash) is risk-free so long as it is in custody of a financial institution. Investors and depositors no longer have clear title to their own assets if they are held in financial accounts. There is now a body of law (including Dodd-Frank) that allows custodial assets to be swept into the bankruptcy estate and be subordinated to senior claims. All this has to do with pooling of cash and securities—once your assets are pooled, you do not have the same level of property rights as when you hold the asset yourself."

New and little understood, Mikhailovich goes on, are the risks attached to pooled securities. Way back when, banks and broker-dealers held stocks and bonds in bearer form. It was obvious who owned them. No more. Financial institutions today hold securities in street name. Like cash, they are fungible, and they are yours until the custodian goes broke, at which point things may get murky.

This is a state of affairs both perverse and pernicious, Mikhailovich winds up: "On the one hand, very, very few know that their property rights are not the same, even after the losses and/or disruptions associated with Refco, Lehman, Cyprus, MF Global and, now, the Swiss-American tax agreement. On the other hand, various rules and practices have made it almost impossible to use physical cash and securities. Go try to make a large cash withdrawal or cash deposit and see what paperwork you would be forced to complete."

Mikhailovich says that these legal, political and administrative facts crystallized his interest in physical gold. "If you have another wealth-preservation vehicle that rivals gold in all its practical aspects, I am all ears," he says.

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Deficits in self-awareness

"[I]t is hard to imagine a world where the main currency is based on an extremely complex code understood by only a few and controlled by even fewer, without accountability, arbitration, or recourse." No it isn't. It's the world we live in.

The author of the quoted remarks, Chicago Fed senior economist François R. Velde, was writing about Bitcoin (he published in the December issue of the Chicago Fed Letter). He might have had the dollar in mind. "Extremely complex?" Try to parse the Fed's Dynamic Stochastic General Equilibrium model (*Grant's*, Oct. 5, 2012). "Without accountability, arbitration, or recourse?" The Federal Open Market Committee to a T.

"A flawed DSGE model missed the biggest credit bubble in a generation," colleague Evan Lorenz observes. "A flawed CPI index might be missing a rise in prices today. Note, for example, as the perceptive David Rosenberg, chief economist at Gluskin, Sheff & Associates, already does, the disparity between market-based price measures, on the one hand, and CPI-measured price measures, on the other.

"Thus," Lorenz proceeds, "home prices are rising at a 12.8% year-over-year rate, according to the S&P Case-Shiller Index, while owners' equivalent rent is up by only 2.2% in the CPI. Airline ticket prices have risen by 5.5%, year-over-year, according to the International Air Transport Association, but by only 0.8% within the CPI. The S&P 500 Restaurant Index shows sales per share rising by 5.3% year-over-year, while the food-away-from-home line item in the CPI index reflects a rise of just 1.9%.

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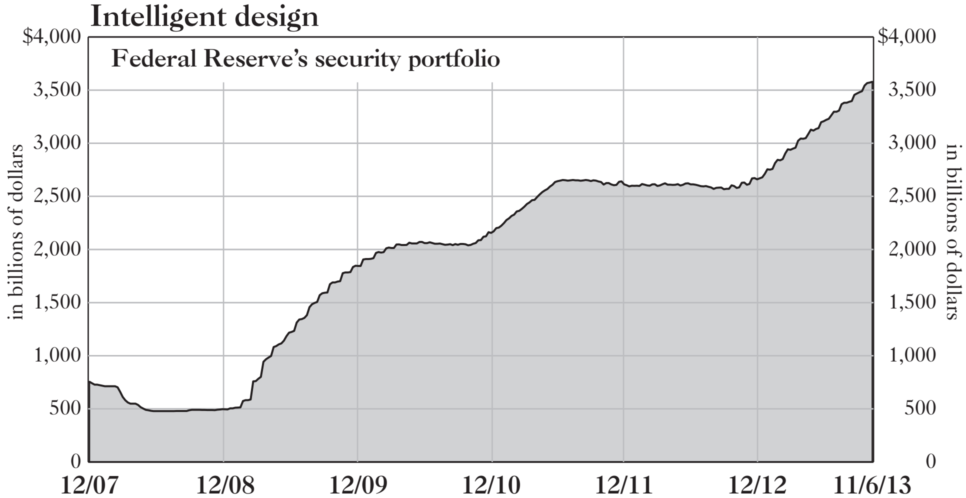

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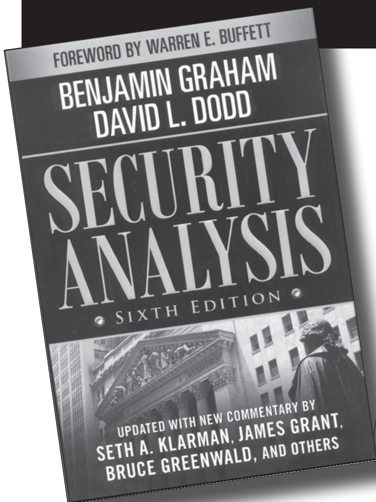

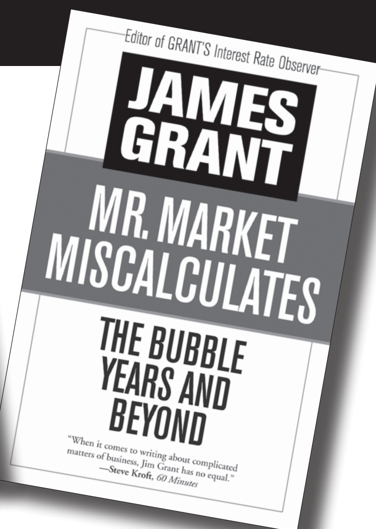

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