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EDITOR

Vacation delectation

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

The attached anthology of ***Grant's*** pieces, both ancient and modern, is not only for you, but also for your friends—and 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 publication with the issue dated Sept. 6.

Sincerely yours,

James Grant

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Demobilizing the reserves

(July 26, 2013) One day soon, banks will have on deposit at the Federal Reserve \$2 trillion more than the rules require them to hold, a mountain of excess reserves that could, at the outer limit of what is theoretically possible in money and banking, support \$20 trillion of new lending. Now under way is a speculation on the meaning of this imminent fact.

All agree that \$2 trillion is a large and complicating figure. Chairman Bernanke insists that it isn't a troubling one. But unless we miss our mark, the Fed will miss *its* mark. It will overstay its inflationary course until it can't reel in the dollars it has so generously paid out. We think the die is already cast.

For signs that the Fed will stay too easy for too long, look no further than the bond market. On talk of a mere "tapering" in asset purchases (never mind cessation, still less of outright sales), the yield on the 10-year Treasury note vaulted to 2.74% from 1.63% in the course of only 46 trading days. World markets shuddered, and the FOMC probably shuddered along with them ("*Holy mackerel, we did that?*"). Buying securities with newly issued dollars is not only the path of least resistance, it is also, to many policymakers, the path of prudence, conscience and duty. It will be hard for the Bernanke Fed to abandon it, and a Yellen Fed would find it no easier.

In modern central banking, the learned practitioners do not just print money (or withhold their printing). They also "communicate," and the burden of what they communicate these days is usually the assurance that they will remain accommodative. Thus, on Feb. 11, 2011, Rep. Mick Mulvaney (R., S.C.) asked Bernanke—the chairman was then testifying before the House of Representatives—why the Fed had decided to buy \$600 billion of Treasurys in its second round of quantitative easing instead of, say, \$500 billion or \$750 billion? "We estimate that the impact on the whole structure of interest rates from \$600 billion is roughly equivalent to a 75 basis-point cut [in interest rates]," Bernanke replied, the funds rate being zero. "So, on that criterion, it seemed that that was about enough to be a significant boost, but not one that was excessive."

"Where's the 10-year?"

QE was tantamount to a rate cut: Such was the message two years ago. But in his Humphrey-Hawkins testimony last week, Bernanke tried to explain why ending, or tapering, QE would not be tantamount to a rate hike. "[E]ven after purchases end," said the new and revised version of the Bernanke text, "the Federal Reserve will be holding its stock of Treasury and agency securities off the market and reinvesting the proceeds from maturing securities, which will continue to put downward pressure on longer-term interest rates, support mortgage markets and help to make broader financial conditions more accommodative."

Possibly, the chairman means to communicate a yield-curve stratagem. Other things being the same, the greater the distance between funds and 30s, the brighter the prospects for economic growth. By pledging to hold the funds rate at zero while letting the long-bond yield lift, the Fed might be hoping to bring about the good things a steeper curve could help to deliver. Then, again, how would the Fed muscle down the funds rate except by the inflationary monetization of government securities? It's a conundrum.

Some would interject that even \$2 trillion of excess reserves present no inflationary threat if the apparatus of lending and borrowing is impaired. In that money and banking class you wish you had not slept through, the professor explained that banks may lend and relend these funds up to the inverse of the reserve ratio. Thus, a 10% reserve ratio would provide scope for \$10 of new credit for each

$1 of excess reserves—assuming a normally fluid banking situation. But when borrowers aren't borrowing, latent lending power goes unused. (A slightly technical point: To the banks in whose Fed accounts the money is deposited, "excess reserves" are cash, a perfectly suitable asset for use as collateral in futures and derivatives transactions. So that $2 trillion may not be entirely idle after all.)

The chairman, a scholar in his previous life, values punctilious accuracy in speech and writing (the Fed does "not literally" print money, he helpfully pointed out last week; the Bureau of Engraving and Printing is the one with ink on its fingers). So, in support of the cause of accuracy, we note that the Fed has retired the *datum* excess reserves; under a new rule, banks keep reserves within a range above and below the required level. But the concept of excess reserves lives on, and so—in a do-it-yourself fashion—does the calculation of the now-retired figure. Thus, as of July 10, such balances amounted to $1.983 trillion, within shouting distance of $2 trillion. As recently as year-end 2007, they totaled a mere $1.8 billion (with a "b").

"As a percentage of GDP," relates colleague Evan Lorenz, "excess reserves stand at a never-before-seen 12.4%. Total domestic nonfinancial credit amounts to 254% of GDP, which means that banks are sitting on the potential to increase total credit in America by half. Between 1929 and 2007, excess reserves averaged just 0.5% of GDP (as a rule, of course, bankers prefer not to sit on idle balances, but to make their money sweat). As a percentage of GDP during the unprosperous 1930s, excess reserves peaked in 1935 at 3.4%. They spiked to 6.2% of GDP in 1940, the year Paris fell to Hitler."

Just as noteworthy as the level of excess reserves today is their composition. Of that almost $2 trillion, $738 billion, or 37% of the total, is credited to American branches of foreign banks. Interest-rate arbitrage is one reason for this striking fact. Desire by the managements of foreign banks to accumulate reservoirs of dollars with which to stock the home office in times of need is another reason. Suffice it to say that if the Fed finds it necessary to jack up the interest it pays on reserve balances—today's rate is 25 basis points—Congress will surely demand to know why the taxpayers are enriching the stockholders of non-American financial institutions.

There is another item of background information that bears on the curious distribution of excess reserves. Ever since 2011, the FDIC has dunned its member banks not on the size of their insured deposits but on the difference between their assets and tangible equity. In the case of Bank of America Corp., for instance, the change raised the assessed base to $1,968 billion (that being the difference between assets and tangible equity) from $1,006.8 billion (those being the bank's American deposits). The BofA's assessable base was effectively doubled. Though all banks, foreign and domestic, earn one-quarter of one percent on their deposits at the Fed, American banks wind up paying the FDIC between five and 45 basis points on those same deposits (the exact levy depends on the regulators' assessment of a particular bank's safety and soundness). For many of these institutional depositors, it's a break-even proposition, at best.

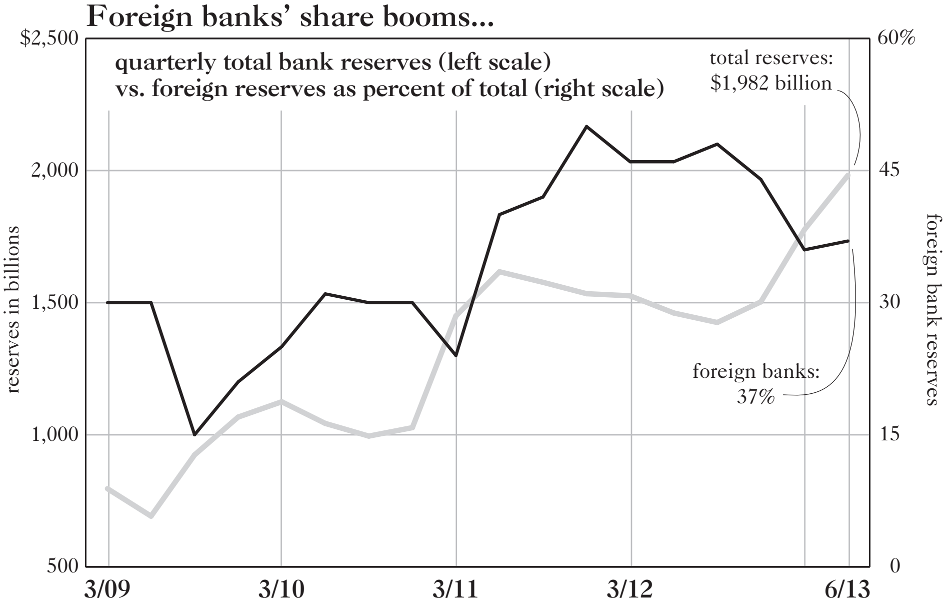
Because the American branches of foreign banks are not so inclined as homegrown institutions to lend in the 50 states, the excess reserves that the foreign banks control are less likely to find their way into the American financial bloodstream than are the American banks' balances at the Fed. So let us set aside the foreign banks' share of that nearly $2 trillion figure. Still, that leaves $1.2 trillion in excess balances in the accounts of American-chartered banks, equivalent to 7.8% of GDP. That, too, is a record-high reading.

Anyway, apologists for the Fed argue, there is no realistic risk of these immense sums doing inflationary mischief. With the power to pay interest on excess reserves (granted by an act of Congress in October 2008), the central bank is the master of the dollars it conjured. If it chooses to bottle them up inside the Federal Reserve System, it can simply pay the banks not to withdraw them. Problem solved, or so the argument runs.

Yet the banks, as noted—the American ones—are earning little to nothing on those balances at the current, 25 basis-point deposit rate. How little becomes clear when one compares one-quarter of 1% with the 4.61% that the banks are earning today on jumbo mortgage loans to prime borrowers (see *Grant's*, July 12). If the Fed would manipulate the banks with high deposit rates, the very same Fed has committed to medicate the labor market with low deposit rates.

"Besides," Lorenz observes, "the Federal Reserve is earning the same rock-bottom interest rates that Bernanke et al. have stuck the rest of us with. In 2012, the system's earning assets delivered a return of 2.9%, down from 3.3% in 2011 and 3.7% in 2010. Maybe the yield is on its way to 2.5% (no disclosure on this point till

Foreign banks' share booms...

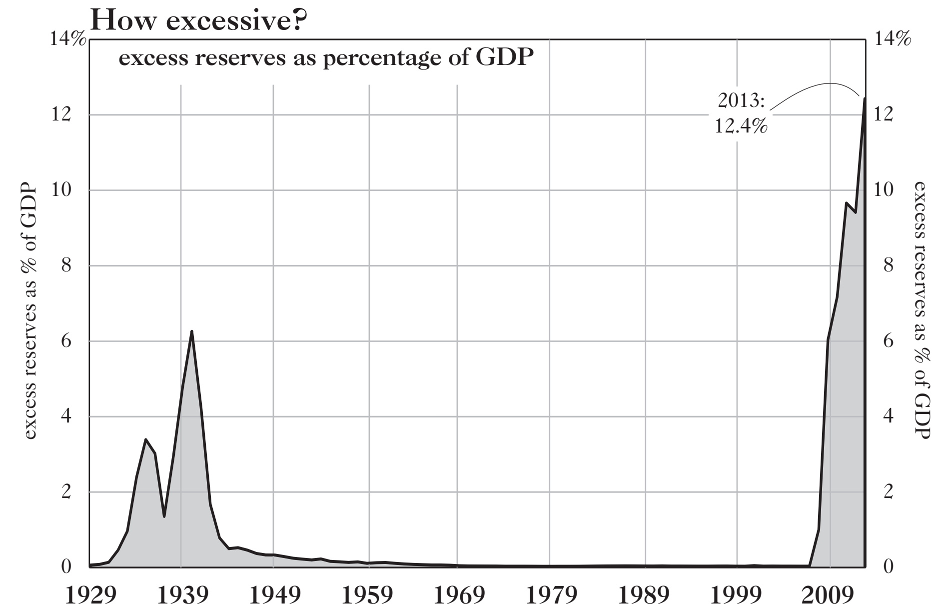


source: Federal Reserve

year-end). It wouldn't be surprising in view of the Fed's continued purchase through QE of $85 billion a month of low-yielding Treasurys and MBS.

"The yield is meaningful because it defines how much the Fed can pay on reserves before it pays out all its earnings," Lorenz continues. "If the Fed were earning 2.5%, the top interest rate it could afford to pay would be 4.3%. At 2%, it could afford to pay only 3.4%. You ask: Why couldn't the central bank simply buy more Treasurys and more MBS with which to earn the income from which it could bribe its member banks not to withdraw their deposits to feed a new inflation? Well, it could. But where would it stop? And what would Mr. Bond Market say about a new adventure in quantitative easing at what would arguably be exactly the wrong time?"

For that matter, what would the House, the Senate and the White House say? Over the past three years, the Fed has contributed mightily to the federal budget. Its QE-generated earnings have chipped in an average of about 3½% of annual federal receipts. How would it fly in sequester-minded Washington if the former monetary sugar daddy announced that it was not, after all, remitting funds to the Treasury, because it was paying out those



source: Federal Reserve Bank of St. Louis, Bureau of Economic Analysis, Banking and Monetary Statistics 1941-1970

billions instead to its banking clientele, not forgetting the foreign cohort?

The Bank of Bernanke can be seen as a prisoner in a monetary jailhouse of its own construction. Interest rates and the yield curve will block the exits. So will budgetary politics. One day—timing, as usual, uncertain—the chairman or his successor will try to neutralize, sterilize or immobilize the excess reserves that today lie idle (more or less) in the system's computers. We say that those dollars will prove harder to squelch than they were to create.

In 1934, the economics faculty of Columbia University organized publication of a big fat book entitled, "The Banking Situation." Excess reserves were then a concern, just as they are today. But they would not necessarily prove inflationary, wrote one of the contributors to the volume, Louis Shere, since they would not be mobilized until the demand for business credit picked up. But, Shere went on, a central bank in conscience could create only so many reserves, "because it is quite conceivable that if a huge amount of credit is created in the lean years, perhaps when the money lever is more or less inoperative, the Federal Reserve Banks could not 'mop up' the supply in early revival without breaking the bond market. Under these circumstances, the foundation would be laid for the next collapse."

In point of fact, the bond market in the 1930s went unbroken. But as for the 2000s, we say: Stand by!

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If accountants ruled the world

(June 28, 2013) In the second quarter, the net asset value of the portfolio that Ben S. Bernanke manages declined by one-third of 1%. In contrast, the net asset value of the portfolio that Bill Gross manages declined by 5.2%. How did the chairman, a non-moneymaker, outperform Gross, a storied moneybags? Especially how did Bernanke achieve this distinction with a portfolio leveraged 63:1? Footnotes to the Fed's H.4.1 report reveal Bernanke's secret: the Fed refrains from marking its securities to market.

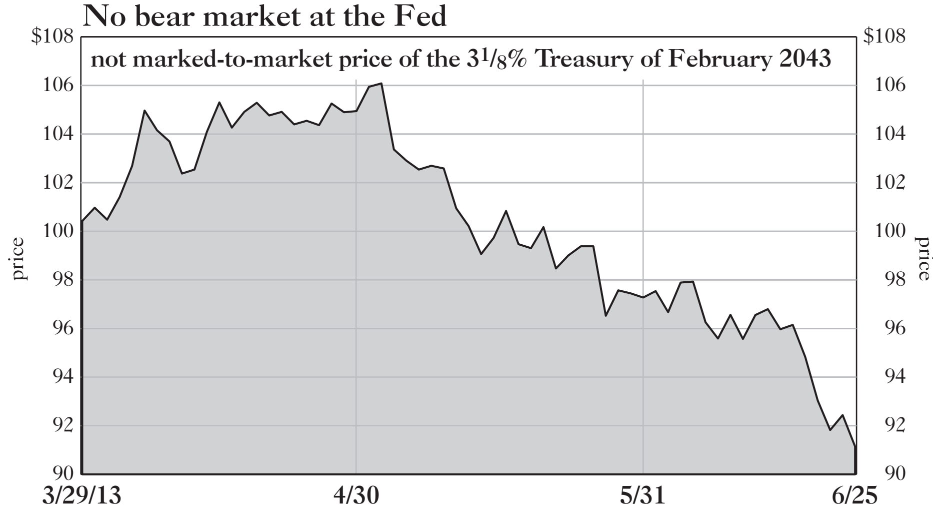
A bank that the Fed regulates may refrain from marking to market securities it designates "held to maturity." The Fed is not one of these regulated institutions, of course, though it might, at some level of consciousness, be admitting that it will never sell the trillions it's accumulated under QE.

Although the Fed doesn't say much about its holdings, it does segment them by maturity. "Based on the market performance of similarly dated securities," colleague Evan Lorenz reports, "it would appear that the Fed lost—or would have lost, on a mark—$155.9 billion on the notes and bonds and MBS it held as of March 27, a sum nearly three times its stated $55 billion in equity (I make no attempt to reckon the loss on securities purchased after the start of the second quarter). Of course, as the Fed muttered into its sleeve in a footnote to the H.4.1 form dated Jan. 6, 2011, the Treasury would be on the hook for realized losses on the Fed's balance sheet, not the Bank of Bernanke."

Meanwhile, in Shanghai—the People's Bank of China, incidentally, is leveraged 1,133:1—short-term interest rates briefly spiked to 20% on June 20, compared to an average of 2.5% in the first five months of the year. Rumors swirled that the PBoC had extended a record-setting advance of the equivalent of $8.1 billion to Bank of China Ltd., China's fourth-largest bank with $2.1 trillion in assets. In response to whispers that it was in default on certain obligations, BoC took to its microblog to deny it.

"It's not that there's no money,"the PBoC remarked on Monday through the Xinhua News Agency, the party's official press agency, "it's that the money is not in the right places." Well and truly said, PBoC!

No bear market at the Fed



source: The Bloomberg

"Corporate China is already groaning under debt," Lorenz points out. "On June 17, China's *Securities Times* reported that the debt burden of Chinese companies reached Rmb. 65 trillion in 2012, or 125% of output. Last week, Youngor Group was either unwilling or unable to borrow funds to complete a Rmb. 2.42 billion ($393 million) purchase of land in Hangzhou, Zhejiang province. In so backpedaling, Youngor will forfeit a Rmb. 480 million deposit."

Assuredly, accountants do not rule the world.

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Nuclear option

(May 3, 2013) Before Babcock & Wilcox Co. (BWC on the Big Board) got into the nuclear power business, it was in the coal-fired power business, and before it became the Navy's virtual nuclear power monopolist, it was outfitting the engine rooms of President Teddy Roosevelt's Great White Fleet. Now unfolding is a bullish analysis of an underachieving stock.

Founded in 1867, B&W has a string of engineering firsts to its credit. But McDermott International Inc. (MDR), which acquired B&W in 1978, seems to have overlooked the fact that the company's innovative boilers were sheathed with asbestos. Faced with the wrath of the mesothelioma bar, McDermott cast B&W into bankruptcy in 2000, from which judicial kerosene bath B&W emerged in 2006. In 2010, the parent spun off its problem child to McDermott shareholders, one share of BWC for every two shares of MDR.

Today, B&W operates in four segments: power generation (54% of 2012 revenues), nuclear operations (33%), nuclear energy (10%) and technical services (3%). The sum of the parts is more valuable than the whole, we are about to contend.

The power generation group is the company dray horse. It makes boilers and related equipment for converting coal into steam, as well as equipment to reduce the toxicity of coal-fired emissions. The business isn't quite the relic it may seem. While low natural gas prices today preclude the construction of new coal-fed boilers, there's continuing demand for aftermarket parts and anti-pollution products. Alas, a recent court ruling has pushed back the timetable for the federally mandated installation of pollution-attenuating equipment that B&W would have been happy to produce and sell. Bulls live in hope that the Environmental Protection Administration will rewrite the rules that the courts have found defective, and thereby create more B&W power-generation customers through governmental edict.

The nuclear operations group is B&W's crown jewel. It makes reactors and components for the Navy's nuclear propulsion program.

The nuclear energy group is the company sleeper. It supplies commercial nuclear energy systems and components to public utilities. In addition—this is where the option comes in—it is developing small modular reactors (henceforth, SMRs) to compete with much bigger, much costlier conventional installations.

The technical services group, which protects top-secret nuclear sites, has become the company laughingstock. Last July, the B&W unit was on guard at the Y-12 National Security Complex at Oak Ridge, Tenn., when an 82-year-old nun, among others, walked through its supposedly impregnable defenses. B&W may or may not get to keep that particular government contract.

Babcock & Wilcox shares are quoted in the stock market at 11.9 times the 2013 estimate, in line with such comps as KBR Inc. and Fluor Corp. But, as colleague Evan Lorenz points out, B&W is not quite comparable. True, results of the power-generation group cyclically fluctuate, but the crown jewel is winningly stable. "We love the nuclear business—the naval nuclear business," a B&W investor, who asks to remain anonymous, tells Lorenz. "It's the kind of business that—they would never want me to say this—but it is basically a monopoly. They are the only ones able to build these naval nuclear reactors. They are the only ones who can go in and refuel them. We think that it is one of the most protected programs out there."

"How should the market value the nuclear operations group?" Lorenz asks. And he answers himself: "Noncyclical companies like Procter & Gamble and Colgate-Palmolive command multiples of enterprise value (equity cap plus debt minus cash) to EBITDA (earnings before interest, taxes, depreciation and amortization) in the neighborhood of 14 times. While B&W's nuclear operations group may lack the brand cache of P&G or Colgate, it has staying power, and, arguably, even more predictable cash flows than such all-American brands as Crest or Science Diet can generate.

"But let us capitalize the $258 million of EBITDA that B&W produces in the nuclear operations group not at 14 times but at 10 times," Lorenz goes on. "Such a multiple would imply per-share value of $22.59, the lion's share of the current share price of $27.20."

Best is yet to come

source: The Bloomberg

Which brings us to the company sleeper, the division that houses the B&W effort to produce the aforementioned pint-size reactor. The design, called mPower, is a 180-megawatt, light-water unit only one-fifth to one-tenth the size of conventional reactors. No need to plant mPower near a big body of water: it's designed to be cooled by air as well as by water. And no need to cart away the spent fuel: mPower's can be stored on site. As to refueling, once every four years will suffice, compared to the standard 18 to 24 months for the kind of reactor that powers such legacy nukes as Indian Point Energy Center north of New York City or Calvert Cliffs Nuclear Power south of Annapolis. Then, too, the mPower is designed to be planted underground, a likely deterrent, notes Lorenz, against octogenarian nuns or crashing planes.

B&W is conducting tests and preparing for the day it might install the first mPower plant at the Clinch River site of the Tennessee Valley Authority at Oak Ridge, Tenn. The company holds a clear lead in SMR technology. B&W, and B&W alone, was chosen last year to receive Department of Energy funds to build a prototype—the DoE had intended to bestow the funds on two contestants, but could identify no credible runner-up to Babcock & Wilcox. It's not a matter of technology but of time, the bull argument goes. "They will get up and running in 2020," our informant says. "How much do you want to pay for that? How many of these things do you think will get sold?"

Not an easy question. To reply, just venture an accurate forecast of the price of natural gas six years hence. Or take a stab at the hypothetical demand for clean electrical power in China and India a half-decade down the road. Or on the U.S. government's demand for power sources for far-flung military bases in the not foreseeable future.

In the meantime, B&W spends real—not hypothetical—money to finance research and development. It laid out $113 million in 2012. Another $85 million to $95 million is in the budget for 2013, over and above fed-

Babcock & Wilcox Co.
(in $ millions, except per-share data)

	2012	2011	2010	2009	2008
Power generation	$ 1,786	$ 1,542	$ 1,425	$ 1,658	$ n/a
Nuclear operations	1,098	1,043	996	914	n/a
Technical services	108	120	90	120	n/a
Nuclear energy	326	321	196	175	n/a
Adjustments & eliminations	(26)	(74)	(18)	(12)	n/a
Total revenue	3,291	2,952	2,689	2,855	3,399
Pretax profit	319	94	220	272	(53)
Net income	228	78	140	172	16
Diluted EPS	$1.91	$0.66	$1.19	$1.46	$0.14
Diluted shares (in millions)	119	118	118	117	117
Total assets	$ 2,840	$ 2,789	$ 2,501	$ 2,604	$ 2,507
Net debt	(363)	(401)	(385)	(459)	(265)
Pension, other post retirement	650	667	663	805	773

source: company reports

eral grants. Well aware of these costs is the front office.

"At current valuations, the market is assigning a value of just about zero to mPower," Lorenz observes. "It seems the wrong value. Say that the project proves to be a dead end, and one day B&W stops funding it. At that moment, EPS would climb by 52 cents. Assuming that the shares continue to trade at 11.9 times earnings, this would add $6.19 to the BWC price. Maybe, though, the technology will come into its own. 'These things would sell like candy in China,' a bullish partisan says. Well, yes—maybe.

"So mPower could deliver a lift to the stock price either by adding value through future sales or by meeting a timely end. The risk to the shares is that the project neither immediately fails nor ultimately succeeds, but drags on and on."

B&W is one year into the regime of CEO E. James Ferland. The former head of the America division of Westinghouse Electric Co., a subsidiary of Toshiba Corp., Ferland has announced plans to cut expenses by $40 to $50 million a year by mid-2015; the one-time cost of the economy drive is $60 million. On Nov. 7, Ferland unveiled a $250 million share-buyback program and an $0.08 per-quarter dividend (current yield 1.2%). While these are steps that any proper fiduciary could or should take, there is something to be said for doing the thing.

As to the balance sheet, B&W has net cash of $363 million, but an underfunded pension plan; $579.2 million is the actuarial deficit, while other post-retirement benefit obligations foot to $71.2 million. Management has taken a number of steps to mitigate its pension problem. For one thing, it has frozen the plan, effective in 2015. For another, it has rejiggered plan accounting such that plan losses are recognized as soon as they are incurred. (In this way, past amortization charges no longer weigh on current results.) Finally, the government reimburses B&W for pension costs of those employees who work on Navy contracts. Though the savings do not show up in the GAAP accounts, government assistance reduces B&W's underfunding by about two-fifths.

If you, gentle reader, were in CEO Ferland's shoes, would you not write a check to buy some B&W stock in the open market to express both your conviction about the future and your solidarity with the public investors? You might—we certainly would—though Ferland, as of the last report, had not.

And if you were running a business engaged in, among other needful activities, carbon dioxide control, particulate and dust control, mercury control and sulfur dioxide control, would you be content with generating all but 11% of your top line in the United States and Canada? Certainly not. You would outfit the sales force with gas masks and send them to China. As it is, the People's Republic accounts for just 1.4% of revenue. "We have a number of specific activities under way internally to try to grow our international presence," Jenny L. Apker, treasurer, vice president-investor relations, advises Lorenz. "We are actively exploring the best entrée for B&W in the Chinese environmental market." Good to hear.

And as for mPower, surely there's an opportunity outside the great state of Tennessee? "While we see potential for our SMRs in the U.S. market, we are not just building this for the U.S. market," Apker comments. "We think there are strong markets for our mPower product outside of the U.S. We have identified markets—Asia, specifically, and the Middle East. In the Middle East, the power needs for desalinization plants are huge and today they are supplied by oil. The major oil producers would rather not be burning their assets if there is an equally cost-effective way for producing power for desalinization. Another market with great potential is China, but there are [also] other markets across Asia, the Middle East and Europe."

Thus, for B&W, it's onward and upward—and, if all goes according to plan, outward, too.

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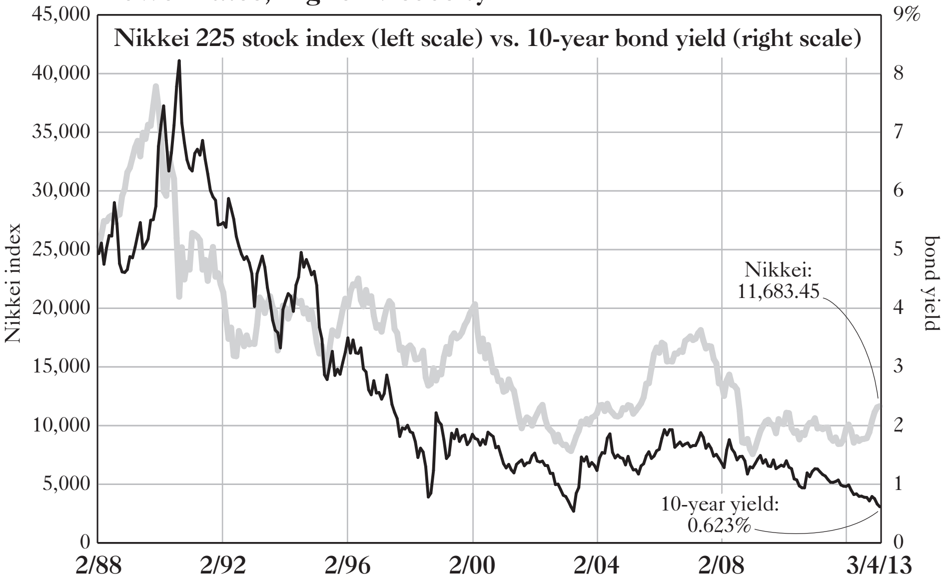
Shot clock for capitalism

(March 8, 2013) Matthew Klecker, a paid-up subscriber from Chicago, was watching a basketball game when he got the big idea. It came to him in a flash that the Fed's toy interest rates give economic actors too much time to stall and dither. Zero-percent rates institutionalize delay in everyday business and investment transactions. They lead to postponement of needed adjustments. It's as if, he said to himself—and subsequently to the editor of *Grant's*—that basketball never got the shot clock.

Sports fans will cringe to recall what the game was like before the National Basketball Association adopted the 24-second rule in the 1954-55 season.

Lower rates, higher viscosity



source: The Bloomberg

(Years later, the National Collegiate Athletic Association imposed the 35-second rule on the men's game, the 30-second rule on the women's game.) In the days before the shot clock, the team holding a late lead could endlessly pass the ball to deny the opposition the chance to score. On Nov. 22, 1950, the Fort Wayne Pistons stalled their way to a 19-18 win over the Minneapolis Lakers, a contest that might easily have been mistaken for an adult game of Keep Away (in the fourth quarter, the two teams combined for a grand total of four points). With his invention of the 24-second rule, Danny Biasone, owner of the Syracuse Nationals, might have saved the NBA. Certainly, he saved the NBA's early television contract.

Anyway, Klecker, 51, a die-hard University of Wisconsin alumnus, started thinking about the tempo of financial and commercial life as he watched his alma mater beat Michigan in overtime last month. "Could not a proper—which is to say a significantly positive—real rate of interest function in the real economy much as a shot clock does in basketball?" he writes. "Let us say, for the sake of this analogy, that economic profits are like basketball points, and the pressure of the shot clock (or lack thereof) in basketball requires shooting dynamism, just as the pressure of a real rate of interest requires economic dynamism. Absent a ticking shot clock, the game can slow to a virtual standstill as an inferior team—in that 1950 stall-a-thon, the Pistons were up against the supremely large and talented George Mikan of the Lakers—may appear nearly the equal of a superior opponent in the low-scoring game that results. Likewise, absent the 'ticking' (accrual) of a proper real rate of interest, poor investments can survive and even appear to be the equal of alternatives that could generate superior returns. No shot clock, fewer shots; no interest accrual, less monetary velocity."

The rate at which base money is converted into commercial credit is one measure of monetary velocity (see the data on pages 6 and 7). But, notes Klecker, the real world of business tells its own story of velocity, or viscosity. "Consider," he bids us, "the case of a sub-investment-grade business that cannot borrow at a cost of 12%, but can at a cost of 7%. It remains in business, though perhaps it should not in the face of a competitor that can properly service the same debt at 12%: Think Japanese 'zombie' companies.

"Or take the case of a completed and largely unsold condominium project that is repossessed by lending banks as the developer defaults in the face of poor sales post-2008," Klecker continues. "I happen to live near one. The reason the building is still unfilled five years after it was built is because the banks, using very low Libor-plus financing, can wait and wait in hopes of higher prices rather than sell at today's clearing price."

High real rates lower the viscosity of the flow of funds, Klecker thus proposes. Low real interest rates raise the viscosity level, in extreme cases to that of molasses. "Both of these examples betray telltale signs of monetary molasses," he goes on. "Repeated worldwide in a myriad of other forms, they generate the feedback loop of lower returns, leading to lower velocity, leading to deflation. The dynamism of competitive returns to capital is diminished. More and more money delivers less and less GDP growth. Malinvestment persists, and the 'beer goggles' of too low rates (a couple of Budweisers, and everything looks better) continually clouds the a priori investment analysis of any thinking capitalist."

The Fed has its interest-rate agenda, of course, Klecker observes, but investors have theirs. Maybe the holders of trillions of dollars in ultra-low-paying sovereign debt will wake up one day to decide that they have lost confidence in the governments that promise to pay negligible yields in currencies that they themselves print to excess. A bond bear market begins. Real rates of interest rise. But the bear bond market proves not a curse but a kind of blessing.

Yes, many would bear mark-to-market losses. But there would be some compensation in the quickening of the commercial and financial tempo. "A certain dynamism would be restored to the real economy via the accelerated liquidation of assets in response to higher carrying costs (e.g., real estate)," Klecker winds up. "A certain dynamism would be restored when a proper cost of capital is charged to a corporate borrower instead of an inappropriately low one (e.g., a single-B credit lives to service a 7% debt, depriving capital to another, more dynamic single-B borrower that could service the same debt at 12%). And, of course, a certain dynamism would be restored to the functioning of our public sector if the Treasury had to pay a rate of interest in excess of the observed rate of rise of the price level."

In Syracuse, N.Y., stands a small monument to Biasone's 24-second shot clock. Come the return of conventionally sized real interest rates, this publication will propose to erect a monument to Matthew E. Klecker, interest-rate theorist—and Badger fan.

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Rain of grain

(March 8, 2013) Do you happen to know when the nation's farmers planted more acres to corn than the consensus of informed opinion expects them to plant in 2013? The year was 1936. Or when farmland values in the five-state Seventh Federal Reserve District (the headquarters of which are in Chicago) appreciated as much over a three-year period as they did in the ZIRP-facilitated boom of 2010-12? It was in 1974-76. Now unspooling is the *Grant's* farm report. Cropland values, money printing and wheat are on the agenda.

Concerning the ruinous drought of 2012, Ben S. Bernanke has—as far as we can determine—clean hands. Yet, although the chairman personally raises not one bushel of corn or wheat, his experimental monetary policies affect all who do. Exhibit No. 1 is the continuing updraft in agricultural land values.

In constant dollars, reports the February edition of the *AgLetter* published by the Federal Reserve Bank of Chicago, "good" quality Seventh District farmland—i.e., Illinois, Indiana, Iowa, Michigan and Wisconsin—registered a 14% gain in 2012, the third highest in 35 years. Over the past three years, Seventh District land prices leapt by 52%, the most since the mid-1970s, when the CPI was roaring along at annual rates of between 5% and 12%.

Well does your editor recall the obloquy that was heaped on the then Fed chairman, Arthur Burns, for letting the inflationary genie out of the bottle. From the vantage point of 2013, however, Burns seems not so much incompetent as unperceptive or unlucky. Between Jan. 1, 1974, and Dec. 31, 1976, the Fed's balance sheet expanded at annual rates no higher than 9.2% (that was in 1975). Over the same span of years, the real funds rate averaged as little as minus 4.1% and as high as positive 0.8%. By March 1980, the CPI would be zipping along at a year-over-year rate of 14.6%.

Compare and contrast the Bernanke years. Between Jan. 1, 2010, and Dec. 31, 2012, the Fed's balance sheet expanded at annual rates of as much as 20.8% (that was in 2011). Over the same three years, the real funds rate averaged minus 1.8%. Consumer prices rose by an average of 2%.

Chairman Bernanke's admirers will see in this comparison between Burns and himself the vindication of flexibility in policy making. Burns misread his era. He should have tightened but didn't (it's clear as a bell in retrospect). Bernanke, his fans contend, has correctly read *his* era. To beat back deflation, he has conjured trillions of dollars. Only imagine if he hadn't.

It's a funny kind of deflation, only allow us to say, when credit spreads contract, junk bond prices soar and the measured rate of inflation (and how generously measured it is) remains in positive territory. Be that as it may, farmland prices in three Bernanke years more or less matched the gains they recorded in the mid-1970s under Burns, whose name is synonymous with inflation. So far, Bernanke's name is synonymous with that happy form of inflation called a bull market.

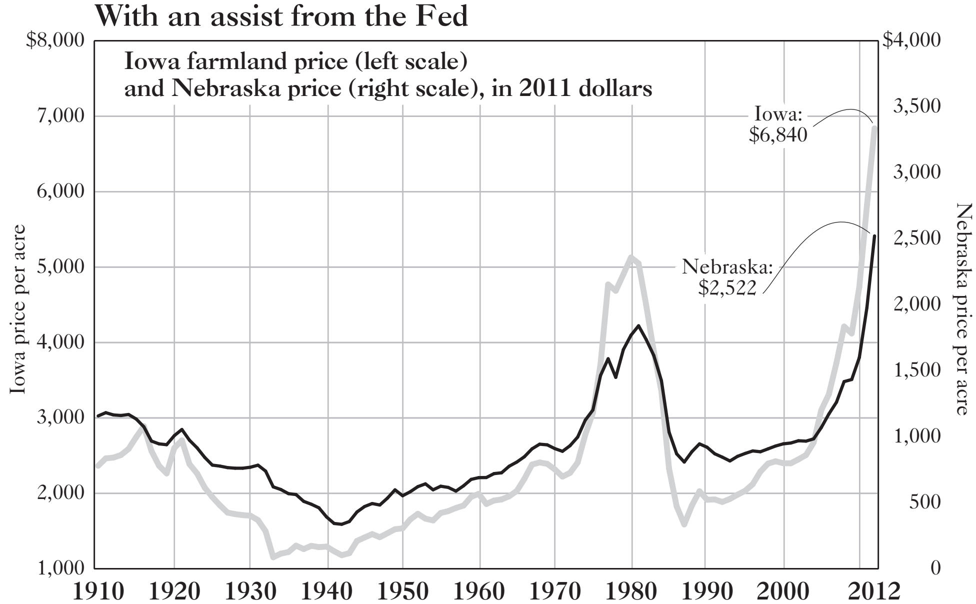
"Perhaps the most surprising aspect of 2012's strong gain in farmland values," the Chicago Fed notes, "was that it occurred in the midst of the worst drought in the Midwest since 1988." Or maybe it's not so surprising. The drought-shortened crop lifted prices, while interest rates charged on land loans dipped to 4.7% in the fourth quarter, a new low, the Chicago Fed reports.

Just how bullish the current alignment of agricultural stars is can hardly be exaggerated. Drought or no drought, American net farm income in 2012 is set to reach $112.8 billion, within a few percentage points of the record set in 2011. "Since 2008," according to a Dec. 10 bulletin from the Congressional Research Service, "farm asset values are up 26% while farm debt has risen by only 10%. As a result, the farm debt-to-asset ratio has declined steadily since 2008 and is expected to fall to 10.6%, its second-lowest level since 1960."

If, in urban America, the so-called new normal is down-in-the-mouth resignation to high rates of joblessness and low rates of economic growth, Midwest farmers seem infused with optimism. "Farmers' capital expenditures—including expenditures on machinery and equipment, trucks and autos, and buildings and facilities—were forecasted by respondents to be even higher in 2013 than in 2012. . . ," the Chicago Fed relates. "With the USDA predicting net farm income to rise 14% from 2012 to $128.2 billion in 2013, there would seem to be at least another leg to be run as farmland values continue their upward race."

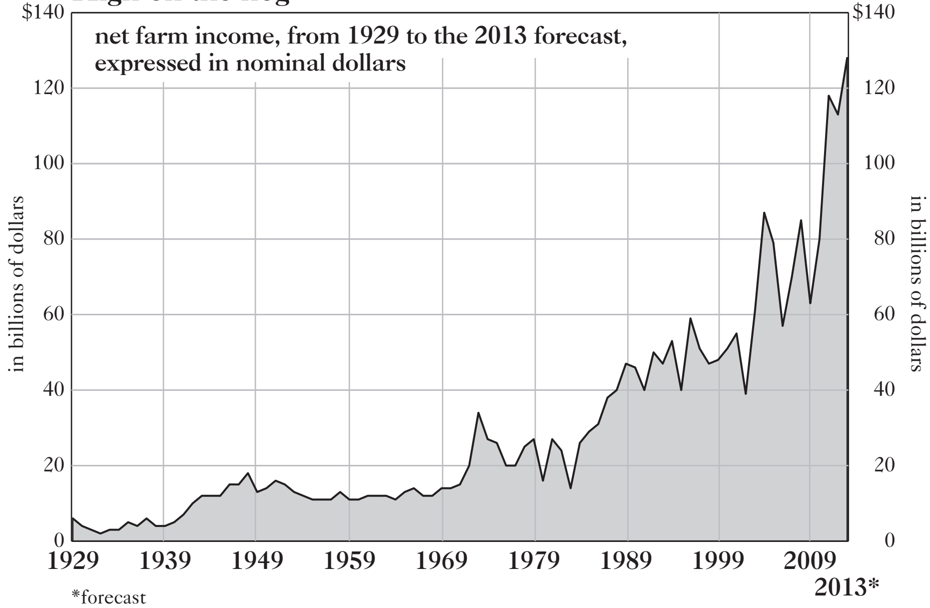
There will soon be a race to the tractor if unofficial forecasts of 2013 planting intentions are on the beam. By the USDA's reckoning, the number of acres to be planted to corn this spring will total 96.5 million. Independent analysts project a total closer to 100 million acres, which, if realized, would be the most since the 102 million acres planted in 1936, when the Dust Bowl ravaged the American midsection and per-bushel yields per acre averaged not today's 160-plus but rather 18.6, the lowest ever recorded in USDA statistics stretching back to 1866. Say that

With an assist from the Fed



sources: Federal Reserve banks of Chicago and Kansas City

High on the hog



*forecast
source: USDA Economic Research Service

American farmers do plant 100 million acres to corn—100 million acres being a little bit smaller than the size of the state of California—and that these acres, of which 95% are harvested, deliver the trend-line yield of 163.6 bushels per acre. The result would be a domestic corn crop of over 16 billion bushels, the most ever.

Such a bounty would be bearish for prices, other things being the same, and not only for corn, but also for the grains that compete with corn—wheat, for example. "Take a legal pad," Keith Bronstein, managing director at Endurance Asset Management and this publication's most valued resource on all things grown in dirt, tells colleague David Peligal, "and draw a line down the middle of the page to determine what's bullish and what's bearish for the grain complex. On the left-hand side, the bullish side, there are two things—and I'm really talking about the 12- to 18-month time frame, and not a five- to 10-year time frame. One is drought, two is a collapse of the dollar. That's it. Case closed.

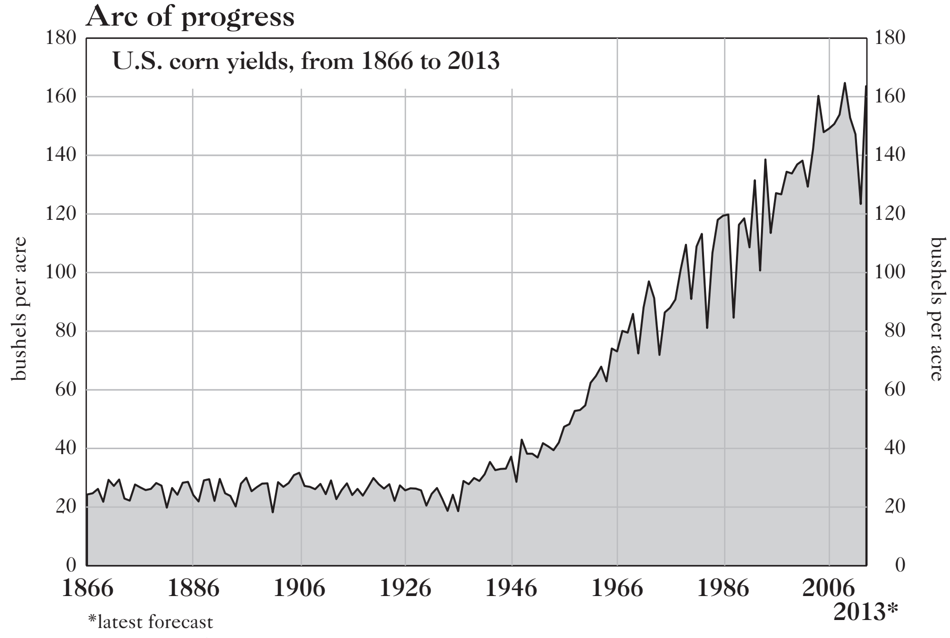
"Now let's begin on the right-hand side of the page by saying that somewhere in the vicinity of 85% of the time, weather is normal," Bronstein continues. "Therefore, it's not so crazy to think in terms of normal weather. What does normal weather produce? If you went back in time to last fall, when we saw the corn production in South America, the market cognoscenti said, 'thank God for that because we've had a corn shortfall here in the United States and they're going to fill in the holes of demand until about February or March, and then they'll run dry and then look out above, because now the United States is the only source of supply.'

"Well," Bronstein goes on, "that premise was completely wrong. So what happened? One is, they're still selling corn. It's not magic. It's just that their corn supplies were maybe a little bit bigger and the demand worldwide for corn wasn't that it was so much less … just that it was continually satisfied by various alternatives. One of those alternatives is feed wheat. India is selling feed wheat into traditional corn-consuming channels. That has never happened before. And all of a sudden, that's filling holes. It's the old story that the cure for high prices is high prices. And we had a couple of years of high corn prices and poor supplies, and the world has done what the world does. It adjusts. Now, logistically and in terms of overall supplies, it's still going to be dicey for the next few months. I'm not pretending it won't be. But we're kind of getting through this without having anything hysterical happen in terms of price."

Of course, as the USDA's own chief economist, Joseph Glauber, recently observed, one might have said the same thing last year. Indeed, many did. "Yet," Glauber notes, "instead of a record corn crop, we saw record high corn prices. Instead of [cattle] herd rebuilding, there was further liquidation as livestock margins tightened. So while the outlook for 2013 remains bright, there are many uncertainties."

To be sure, Bronstein concurs, nothing is certain. But some things are fairly dependable. "Going back to my days at the Chicago Board of Trade, there was an aphorism: 'Short crops have long tails.' Four of the last five crop cycles have been short crops. We've had two bad crops out of three in South America and two in the United States. So we could be setting up for one of the biggest tails anyone has

Arc of progress



*latest forecast
source: USDA

ever seen." That is, given some normal weather, crops could be immense, with prices to match.

And if corn prices tumble, so would wheat prices. Especially vulnerable would be wheat for December delivery, pitched as it is at a premium of $1.79 per bushel over corn. Yet, in the here and now—see the contracts for May delivery—the two grains are quoted within two cents of each other. At such a small premium to corn, wheat is today being served to poultry and livestock in the American Southwest and Southeast. The critters would have to make do with corn alone if the December price relationship, wheat to corn, persisted.

"How are we going to get—or keep—wheat into feed rations," Bronstein muses. "Well, it's going to have to get considerably cheaper on corn. It's going to be a race, and if we had this normal yield I'm talking about in corn, this is going to be a race to the bottom. And wheat has given corn a big head start, so a lot of that space has to be filled in. I think that while corn prices, in a normal yield scenario, have reasonable downside in the December forward futures, wheat potentially has a much greater downside. The wheat price is really sticking up there like somebody's got to take a hammer and hit it."

Reflecting on the continued ascension of land prices, Mike Duffy, Iowa State University economics professor and surveyor in chief at the annual Iowa Land Value Survey, marveled that 2012 was "one of the most remarkable years in Iowa land value history. This is the highest state value recorded by the survey, and the first time county averages have reached levels over $10,000 [per acre]. While this is an interesting time, there is considerable uncertainty surrounding future land values."

Duffy could say that again. Only consider that prime Iowa corn ground is trading at $11,000 an acre. Assume that this rich earth brings forth 200 bushels an acre, and that the landlord captures 35% of the gross. At $7 a bushel, today's elevated spot corn price, a landlord would earn a pretax rental yield of approximately 4.45%. At $4.50 a bushel—not an unreasonable expectation for this season, we think—the rental yield would drop to 2.86%. At $1.94—the average corn price as recently as 2005—the yield would dip to $1.23%. Then, again, land prices would probably do a little dipping themselves.

"Of course," Peligal notes, "there's more to agricultural America than the Midwest. The Palouse region of eastern Washington has begun to attract some value-seeking land buyers. This is the dryland portion of eastern Washington, which receives such rain as the gods choose to dispense from moisture coming off the Pacific. Never to be confused with the sprawling Corn Belt, the Palouse produces soft white wheat, which makes its way to China and Japan and then into noodles and dumplings.

"The spot price of old crop wheat today is a very full $7 a bushel," Peligal continues. "The Palouse can serve up 90 bushels of wheat per acre. Again assuming a 35%/65% split, landlord and farmer, the landlord would be looking at pretax income per acre of $220. Divided by a land price on the order of $3,000 per acre—up from about $1,500 per acre five years ago—he or she would be looking at a pretax yield of 7.4%. But, again, we think, grain prices are due for a tumble. At $5 a bushel, our hypothetical landlord is looking at a yield of 5.3%; at $4 a bushel, a yield of 4.2%. This is hardly the stuff of Armageddon. But just as Bronstein says, markets do adjust."

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For the unrepressed

(February 22, 2013) David M. Rubenstein, founder and co-CEO of the Carlyle Group, used the occasion of a talk in Miami last week to recall the arcadia of easy money, effortless fund raising and record-breaking deal making that came to a screeching halt in 2007. Why, said Rubenstein, in that culminating year, the fattest of five fat years, global buyout transactions worth $860 billion were signed, sealed and delivered.

But then—wouldn't you know it?—proceeded five lean years. In the upswing, all seemed certain, but in the bad times, doubt descended. "[A]ll the deals that were done in the golden age," Rubenstein mused, "would they survive? No. 2, would the firms themselves survive, because they had done so many deals that didn't look good, would they be around? No. 3, would investors fund their capital?"

To each of these questions, Rubenstein was able to reply "yes." Of the 25 biggest deals done in the golden age, he said, only two failed. The largest private equity funds survived, and the limited partners met their financial commitments. So the world loves the big public purveyors of private equity and so-called alternative assets? It absolutely does not, on which fact hangs a story.

Blackstone (BX on the New York Stock Exchange) and KKR & Co. (KKR, also on the Big Board) are the subjects at hand. However, as usual, interest rates, even our tiny ones, lurk not far offstage. While the Federal Reserve has managed to "repress" Mom and Pop with its zero-percent funds rate, it has not so much as laid a glove on Henry R. Kravis—or, in view of the new Heinz acquisition, on Warren Buffett, either. In preview, we remain bullish on BX (see *Grant's*, Oct. 7, 2011, and July 27, 2012). And we stake out a new bullish position in KKR, which, over the trailing 12 months, paid out a 6.8% dividend, 70 basis points higher than today's average junk-bond yield. It isn't every cycle in which the common equity of a private equity firm outyields the speculative-grade debt that that firm's client companies use to go private.

KKR and Blackstone should be the easiest businesses in the world to understand. They raise money. It is theirs for 10 years and more. They invest it—KKR, chiefly in private equity, Blackstone in p.e. plus real estate, hedge funds and credit funds. They derive fees of 1.5% a year and a carried interest of 20% on successful investments. The businesses grow and grow, and the earnings compound and compound.

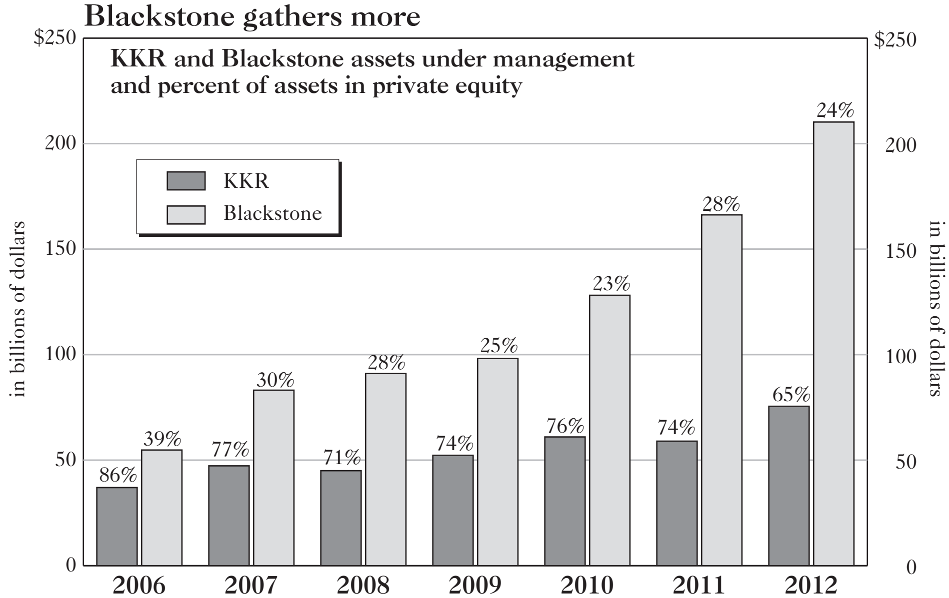
But you open up the companies' SEC filings and you shake your head in dismay. Non-cash charges litter the profit and loss statement. The balance sheet is swollen with the assets and liabilities of consolidated portfolio companies. Then, too, the shareholders of KKR and Blackstone are not exactly shareholders; rather, they are "unit holders." The difference is not important except at tax time, when the unit holders receive a Schedule K-1 in the mail. "As a partner in a partnership," KKR advises, "you are taxed on your allocable share of KKR's income, irrespective of whether cash distributions are made to you." It's as if you were a partner in a hedge fund.

"For the unit holders' sake as well as for its own," colleague Evan Lorenz notes, "the alternative-investments industry reports 'economic net income,' a non-GAAP measure of pretax income as well as results according to GAAP. Economic net income erases non-cash charges as well as certain revenues and certain expenses at company-managed funds. And ENI encompasses unrealized gains in portfolio investments as well as realized ones. The difference between GAAP-sanctioned net income and company-sponsored ENI can be enormous. Thus, KKR trades at 8.1 times trailing GAAP net income but at only 6.2 times trailing ENI. Blackstone trades at 46.7 times trailing net income but only 10.8 times ENI.

Mr. Market, who refuses to cotton to ENI, has a bad taste in his mouth about BX and KKR. The former came public at the very peak of the market in June 2007. The latter went public through a reverse merger with a Guernsey-listed affiliate that finally produced the NYSE-listed KKR in 2010. Then, too, there seemed something fishy about the firms whose very reason for being was private ownerships selling shares in themselves to the public. "Mark my words," said the writer of a comment on the DealBook story disclosing Kravis's filing for a Big Board listing, "KKR will cash out their private holdings and common investors will be left holding the bag. Common investors, beware thieves of PE are circling in the water. They are vultures and sharks. They will steal your hard-earned money."

It's our contention, rather, that the public can steal the shares, or units, of Blackstone and KKR—especially at today's valuations. The principal risk to this lawful taking is an explosion in our central bank-manhandled financial markets. In his talk, Rubenstein pointed out that the private equity business has flourished in all seasons of credit and interest rates. Against the special hazards presented by today's monetary policy, compelling equity valuations provide a

Blackstone gathers more



source: company reports

layer or two of welcome armor.

It takes some peeling back to see that KKR is a very cheap stock. It's quoted today at $18. Net cash per KKR share totals $1.27, investments in company-managed funds another $8.60 per share. Combine the two and subtract from the $18 share price. Now apply a P/E multiple—not even an ENI multiple—to the remainder. What you have is a stock selling at 3.7 times trailing GAAP net income and at 2.8 times adjusted ENI.

Perform the same operation on Blackstone. Subtract the sum of net cash and co-investments per share of $4.49 from the $19.15 share price. What you have is a stock trading at 35.8 times trailing net income and 8.3 times ENI.

"Since we began writing about Blackstone in 2011," Lorenz points out, "the share price has jumped by 61%, to $19.15 from $11.91, while assets under management have soared by 32%, to $210.2 billion from $158.7 billion. Blackstone, not quite three times bigger than KKR, is the most diversified of the public alternative asset managers. Under its care is $51 billion of assets in private equity, $56.7 billion in real estate, $46.1 billion in hedge funds of one stripe or another and $56.4 billion in credit funds."

Much smaller and less diversified than Blackstone, KKR is a freak of capitalistic nature. Founded in 1976, it has produced returns of 26% per annum since inception (a fact in no way to be confused with probable returns over the next 36 years). It was the barbarian at the gate with RJR Nabisco in 1988, and it achieved the largest leveraged corporate transaction of all time with its ill-omened purchase of TXU Corp. in 2007. Today, the company manages $75.5 billion in assets, of which $49.1 billion comprise private equity funds, the specialty of the house, and $26.4 billion consists of public market funds that invest in credit, equities and specialty finance. Of the major public alternative asset managers, KKR has the biggest concentration of assets in private equity.

The TXU debacle speaks volumes about KKR's franchise and survivorship. The $1.8 billion the firm invested in what is today known as Energy Future Holdings Corp. is all but gone—95% has been written off. But KKR's 2006 Fund in which TXU made its pratfall has generated annual returns of 6.9%, thanks to the more than compensating success of HCA Inc. and Dollar General Corp.

"We look at managers in the context of their portfolio, not a specific investment," David Fann, CEO of TorreyCove Capital Partners, an advisory group whose clients are investors in KKR's 2006 Fund, tells Lorenz. "On an overall fund basis, to have achieved approximately 7% IRR at this time in the fund's life, and in spite of the great financial crisis and during a period where some very large buyouts were completed, seems like a reasonably acceptable performance." Since 2006, the (unleveraged) S&P 500 has logged an annual rate of return of 3.3% with dividends reinvested.

Another sign of the strength of the KKR franchise is the non-deflation in the fees it charges; the limited partners may grumble, but they still pay. "The management fees are the same, the carried interest is the same, the fee split we have with our LPs is the same, the economics are the same" Craig Larson, KKR's manager of investor relations, advises Lorenz. There has been one concession, Larson notes, however. Henceforth, as in the firm's new North America Fund XI, there is a 7% hurdle rate—until that rate of profit is cleared, KKR will earn no performance fees.

The fourth quarter was a blowout, with ENI per share showing a 45% year-over-year gain and dividends per share jumping 119% to 70 cents a share. "We returned more cash to our LPs than we have in our 36-year history," says Larson. "So that backdrop is a very positive one when you're talking about fund raising and looking to raise new capital."

This year could deliver some happy surprises, too. While KKR's TXU-laden 2006 Fund has performed creditably, it has yet to deliver performance fees to the sponsor on account of the TXU loss. This is not a hurdle-rate problem (the $16 billion 2006 fund has no such bar to clear), but rather a "netting-hole" problem. Having written down the value of a $100 million investment by, say, $50 million, KKR may harvest no incentive fees until its investors have realized compensating capital gains of at least $50 million.

"Write-downs on investments such as TXU have created a very large hole, indeed," Lorenz relates. "As of Dec. 31, the deficit amounted to $275 million. Last week, KKR and Bain Capital Partners disclosed in a prospectus that they would sell up to 50 million shares in HCA in a secondary offering for a total consideration of $1.9 billion. With this sale, KKR may sew up the netting hole completely. This prospect figures largely in the bull story on KKR: 'The market is ignoring this catalyst, which will highlight KKR's incentive income-generating potential,' one such advocate contends. 'In 2013, the majority of KKR's assets under management will be cash-carry eligible and contributing to distributions for the first time.'"

The listed KKR was seeded with redundant cash and co-investments that today top $7 billion. Blackstone, which manages more than twice as much money as KKR, is somehow able to make do with $5 billion in net cash and co-investments. Might KKR then be contemplating a special dividend or at least a stepped-up regular payout? Not to listen to management: "We are looking at investment opportunities overall from the balance sheet and we get most excited by the ROEs that we get investing off of the franchise and the business rather than doing some special dividend or the like," Larson says. "We look at the growth in the overall balance sheet—that was up 24% in 2012—so we feel pretty good about value creation on the balance sheet instead of just distributing the cash. If we get to a point in time where the balance sheet is so liquid, and we don't see 20%-plus ROE opportunities, we could change our point of view and do some kind of special distribution. But that is not something that I expect we'll see in the near term or the medium term."

Final word goes to the investors who brought Blackstone to the attention to this publication in 2011. Then as now declining to have their names in the paper, the Blackstone—and KKR—bulls say they remain long. The credit backdrop is propitious, they note. The menu of investment choices available to institutions in this time of financial repression remains limited. What's new and different now, they say, is the prospect over the next 12 months for a stepped-up pace of dispositions—and, therefore, for a stepped-up pace of earnings. "The dividends of both [KKR and Blackstone] are going to allow these things to yield over 10% in a low-yield world," as one of those investors says. "You get these things yielding over

10% and growing 25% a year, that's kind of the third piston that is now turning on that has never been on as a public company for these stocks, and we think this year is when the dividend turns on, and the dividend power is very big."

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In case the music stops

(January 25, 2013) Institutionally sponsored bearbaiting arrived on Wall Street with the Jan. 3 debut of a financial instrument created to punish the short sellers. Deutsche Bank is the promoter of this, the "U.S. Short Squeeze Index." The investor who owns it gains an economic interest in a rotating group of 25 American-listed companies that people who actually read financial filings have gone to the trouble of betting against. Probably, we think, Deutsche Bank would not be marketing the index (only to professional investors, incidentally) unless its clients asked for it, and its clients wouldn't have asked unless they were very sure of themselves. Many seem to be.

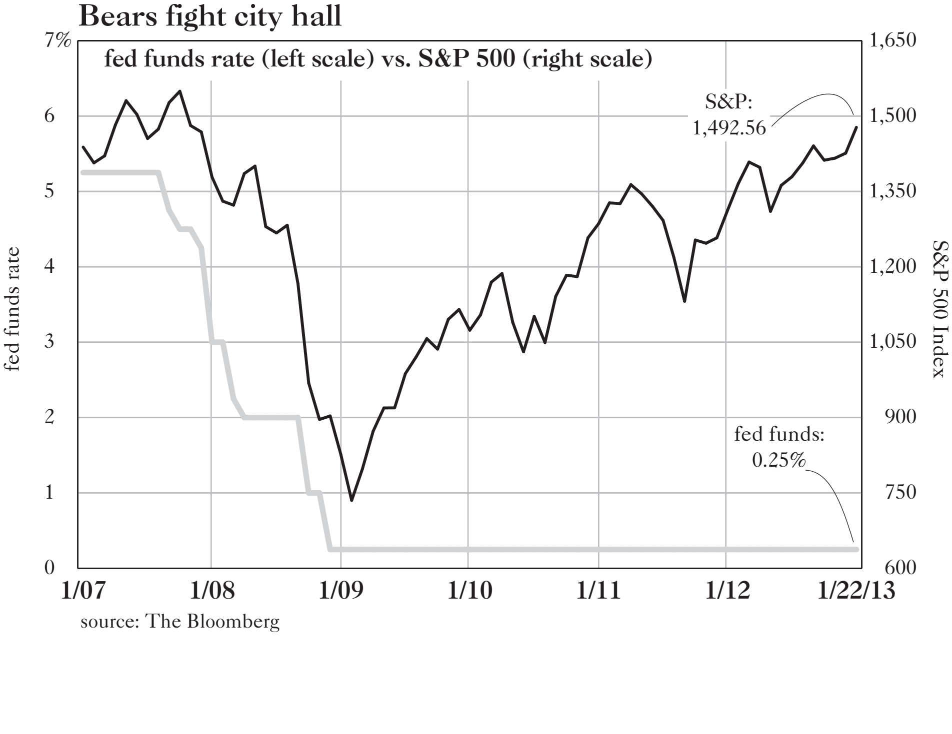
Now begins a survey of the short side of the stock market as well as an analysis of one particular short-sale candidate. Having arrived at the age of wisdom, your editor will forbear from predicting the direction of the S&P 500. However, he will go so far as to say that when—as now—it seems futile to hedge against the downside, it is certainly *not* futile to hedge against the downside.

Rackspace—but there's a price war

source: The Bloomberg

Generically, stocks are better than bonds, let us say—and at current multiples and interest rates, we so believe. And the Great Rotation out of bonds and into stocks is at last under way, let us also say. Suppose that America's economy will surprise by its strength, even in the teeth of the gale-force winds originating in Washington, D.C. Say it's all true. It does not then follow that the investment road is strewn with rose petals. "The market," observes A. Alex Porter, founding partner of Amici Capital, "is a complex system. Complex systems blow up from time to time." Ergo, hedge—at all times.

Bears fight city hall



source: The Bloomberg

Of course, it's not so easy to hedge when the market goes up and up, and when the Federal Reserve buys $85 billion of bonds each month with money that didn't exist until the FOMC conjured it on a computer screen. An insurance policy consisting of a short position in a portfolio of volatile equities is different from a standard homeowners' policy, needless to say. The latter may or may not pay off after a visitation by the storm of the century, but it will never produce marked-to-market losses in a central bank-financed bull stock market. "As long as the music is playing, you've got to get up and dance," infamously quipped Chuck Prince, CEO of Citigroup, in July 2007. The dance floor was crowded when Prince spoke, and—to the strains of Ben S. Bernanke and his Orchestra—it's filling up today.

"Hedge funds are borrowing more to buy equities just as loans by New York Stock Exchange brokers reach the highest in four years, signs of increasing confidence after professional investors trailed the market since 2008," Bloomberg reported on Jan. 14. "Leverage among managers who speculate on rising and falling shares climbed to the highest level to start any year since at least 2004, according to data compiled by Morgan Stanley. Margin debt at NYSE firms rose in November to the most since February 2008, data from NYSE Euronext show." The Bloomberg bulletin quotes James Dunigan, chief investment officer at PNC Wealth Management, as follows: "The first step of increasing risk is just going long, the second part of that is levering up in order to go longer."

Having spent some time on the phone with Porter, who learned the art of hedged investing from the progenitor of the hedge fund, Alfred Winslow Jones himself, colleague David Peligal has wisdom to impart. "Short selling has rarely been easy," Peligal begins by observing. "It wasn't easy in 2006, or in 1999—or, as Porter noted, in the 1960s, when National Student Marketing Corp. doubled in the short sellers' faces, and then doubled again before crashing."

"Different today is ZIRP," Peligal continues. "When nominal rates were measured in more than a few percentage points, the prime brokers paid the short sellers. Now that nominal rates are measured in a small number of basis points, the short sellers pay the brokers. True, there are many fewer buy-ins these days than there used to be, but the cost of borrowing stock, especially heavily shorted stock, has gone way up. Finally, the popularity of exchange-traded funds may make the conscientious analyst wonder why he or she bothers to open the annual report. You might be short a retailer because its inventories are rising faster than its sales or its merchandising is lackluster. But if your particular stock is in the SPDR S&P Retail ETF (ticker: XRT), and if the retail sector is going up, chances are your short-sale target is going up, too. Couple that with the rise in algorithmic trading, and it feels like what happens to the price of the company you shorted (after all that hard work!) has more to do with the S&P or the XRT or the FOMC than with the company fundamentals."

No surprise, then, that the bear population is much reduced, as a *Forbes* piece dated Jan. 10 observes. Maybe the wonder is that there are any short sellers left. Jaime Lester is one of this hardy breed. He is the managing member of Soundpost Partners, New York, whose main fund dates from 2005 and which manages assets of $60 million, down from a peak of $375 million in early 2010. Undaunted, Lester started a short fund in June. He calls it the Soundpost Skeptic Fund, and it manages $20 million. Peligal asked Lester for the name of an actionable short idea, and Lester replied Rackspace Hosting (RAX on the New York Stock Exchange). Having investigated, *Grant's* concurs with Lester.

Founded in 1998 in San Antonio, Texas, Rackspace went public in 2008 and maintains data centers in the United States, the U.K. and Hong Kong. Service deluxe is the corporate watchword. You, a business customer looking for a stairway to the cloud, will be treated like royalty. And you will get the same special handling if you need a server on terra firma. No more are businesses content to spend uncounted billions on the inputs to information technology, e.g., servers, software and the salaries of the people who make them work, according to Lanham Napier, the 40-something Rackspace CEO. The new idea—the Rackspace idea—is economical, carefree "outcomes."

Let it be said that, to date, RAX has been what is euphemistically known in the trade as a "tough short." Valued at 106 times earnings, the shares have generally appreciated and have always been pricey. A triple-digit multiple is proof of the existence of a story, if nothing else, and Rackspace's story is one of booming growth in the centralization of information technology resources on the Internet. Why keep your own server when you can buy just that portion of a server you happen to need over the Net? A business should no more produce and maintain its own IT infrastructure than it should its own electrical generating capacity, is the Rackspace pitch.

In a December research note, J.P. Morgan contends that the migration to the cloud is persistent enough to continue to drive Rackspace's 20% revenue growth. The Morgan analysis dangles a December 2013 price target of $83, which is predicated on sticking a fancy multiple—an enterprise value 16 times EBITDA—on a 2014 estimate. Tuesday's closing price was $76.56. The shares, which pay no dividend, are liquid and easy to borrow; the short interest is less than 10% of the float (not big enough, evidently, to warrant

Rackspace Hosting
(in thousands of dollars, except per-share data)

	12 mos. to 9/30/12	12/31/11	12/31/10	12/31/09	12/31/08	12/31/07
Net revenue	$1,239,591	$1,025,064	$780,555	$628,987	$531,933	$362,017
Cost of revenue	354,874	309,095	249,840	200,943	172,583	118,225
Sales and marketing	150,491	126,505	96,207	79,458	80,323	53,930
General and admin.	335,568	270,581	199,011	168,116	148,706	102,777
Depreciation and amort.	235,775	195,412	155,895	125,229	90,172	56,476
Total costs and expenses	1,076,708	901,593	700,953	573,746	491,784	331,408
Income from operations	162,883	123,471	79,602	55,241	40,149	30,609
Total other inc. (expense)	(5,518)	(7,042)	(8,191)	(8,695)	(7,461)	(2,815)
Income before inc. taxes	157,365	116,429	71,411	46,546	32,688	27,794
Income taxes	56,807	40,018	25,053	16,328	10,985	9,965
Net income	100,558	76,411	46,358	30,218	21,703	17,829
Diluted net inc. per share	0.72	0.55	0.35	0.24	0.19	0.17
Cash and cash equivalents	257,651	159,856	104,941	125,425	238,407	24,937
Total assets	1,241,765	1,026,482	761,577	668,645	685,261	301,813
Long-term obligations	194,943	189,310	133,572	161,024	283,053	96,213
Total stockholders' equity	781,934	599,423	438,863	349,427	269,684	96,873
Price per share	$76.56					
Fully diluted shares outstanding (millions)	148.8					
Market capitalization	$11,392.1					
Price/earnings	106.3x					

source: company filings

admission to the Deutsche Bank Short-Squeeze Index). Earnings are due in mid-February.

No proper short idea hangs on valuation alone, especially these days. Balance-sheet weakness would be a promising thread on which to tug, but Rackspace—despite a recent bump up in capitalized software expense—isn't a balance-sheet story. Still less is it a business-execution story. The "Rackers," as management affectionately knows its more than 4,000 employees, are called to the ideal of "fanatical support," that is, unceasing and cheerful attention to the customer's every need. Rather, Lester advises Peligal, the company's Achilles heel is the competition that Rackspace's very success is ferociously attracting. The newly formed Google Compute Engine is one entrant. Amazon Web Services, now in its 11th year and the acknowledged market leader in the "public cloud" market, is another. There are many more.

"Since the summer," says Lester, "the stock traded from around $40 a share to about $80 a share. So it has roughly doubled in six months. I would argue that the news since the summer has been pretty uniformly negative. Now, there are some positive data points also, but, on balance, I would say this is a company that has had a fair amount of negative news. They missed earnings estimates. They beat sales estimates but by the lowest proportion they had ever beaten it. Historically, they beat sales estimates by 2%; in the last two quarters, they beat by 0.2%—so, very weak quarters. If you look at the growth in their subscriber base, it's decelerating. If you look at their margin structure, it's compressing. They've resorted to more accounting tricks like capitalizing software. They've changed their reporting structure a little bit to obfuscate."

The capitalized software costs relate to OpenStack, Rackspace's open-source cloud-computing platform. To capitalize such outlays adds to assets and income; each is higher, at least in the short term, than it would be if management had chosen to run those costs through the income statement. Over the past four quarters, EBITDA minus capitalized software outlays was effectively flat, a 19% jump in revenue notwithstanding.

"Taking a step back," Lester continues, "the core premise of this business is that I can build a data center and fill it with servers and then lease out that server space to a customer. And I'll call it a 'cloud' or I'll call it 'managed hosting' or whatever I call it. The problem is that there are massive, massive competitors here." Google and Amazon, as noted, do—or try to do—what Rackspace does. So do Microsoft, HP, Dell and Oracle. There's nothing gentlemanly about this competitive jostling. "Amazon Web Services and Microsoft, together with Rackspace Hosting, are staging a price war for their services," said a June bulletin from cloudtimes.org. December brought a parade of 25% and 30% price reductions of cloud-based storage prices by Google, Microsoft and Amazon.

Not only are the Rackspace adversaries big, says Lester, they are also different. Amazon and Google don't have to earn a profit doing what Rackspace does. They have, of course, alternative sources of revenue. Then, again, in fairness to all parties, Rackspace has been beating the competition—much of it, like IBM today or AT&T in the early going, big and seemingly scary—by delivering service that leaves the customers satisfied if not openmouthed.

Observing that Rackspace is no pygmy, either, Peligal asked Lester if the company he's short might be someone's idea of a takeover candidate. "People have certainly put that out there," Lester replied. "It's an $11.5 billion to $12 billion company [in market cap] at this point, with invested capital of about $800 million. The companies that have been rumored to take it over are actually smaller companies. People talked about Dell buying it. Dell had a $5 billion enterprise value until recently. If you wanted to generate $150 million of EBIT from $800 million of invested capital, they can do that if they want to. They just have to invest that capital. I think it's crazy that there's something about Rackspace that means they should pay 15 times invested capital to do that.

"When you've seen these big tech takeovers," Lester continues, "most of the time when they've gotten into really irrational prices, aside from Autonomy [whose acquisition by HP may or may not prove to be fraudulent but is undoubtedly questionable], most of these irrational deals that people cite as having a cloud multiple, they're small companies that can be added to a bigger platform. They're $1 billion to $2 billion acquisitions, whether they're 3Par or Compellent or one of these storage technology companies, or if they're some of these big 'software-as-a-service' revenue multiples for companies like Kenexa or SuccessFactors or some of the 'customer relationship management' companies. They can trade at seven to eight times revenues but they're small revenue numbers. They're really being paid $1 billion to $1.5 billion just for the IP [intellectual property]. Here, you're talking about, with any sort of premium, you're now talking about a $15 billion deal—for nothing. And the question is, 'What sort of board is going to okay that deal in this environment?' I think that's incredibly unlikely."

The aforementioned Rackspace CEO, Lanham Napier, a fifth generation Texan, was quoted as saying in *Texas CEO Magazine* that he doesn't want a "big" company. He wants a "great" company. This was in March, when Rackspace was in the middle of a move to new corporate headquarters it was fashioning out of a 1.2 million-square-foot abandoned San Antonio shopping center. In November, Napier, one of the speakers at a Credit Suisse technology conference, fielded a question about the growing competitive field. "I don't have a crystal ball with respect to how this will emerge," he replied. "I think the secret for us is to play our game, and the cloud is a big market, so what segments are we going to be really competitive in and which ones can we dominate? And I think it's this emerging segmentation around customers with applications who want help in a certain service experience, we can win that. That's what we won in the first round of hosting that made us a victor there, and I think it will play out the same way in this market."

However, just in case he is wrong, Napier has been selling. On Nov. 8, as part of his 10b(5)-1 plan, he exercised and sold 210,494 shares. On Dec. 17 and 18, also as part of his 10b(5)-1 plan, he exercised and sold 46,500 shares. His total holdings consist of roughly 4.57 million shares, of which 892,150 are held directly. Other insiders have been selling, too.

In 2012, *Fortune* magazine named Rackspace one of the "100 Best Companies to Work For." For 2013, *Grant's* names RAX one of the "100 Best Stocks to Sell Short."

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Ben on a broomstick

(November 30, 2012) On Nov. 15, the editor of *Grant's* addressed the Investment Decisions and Behavioral Finance meeting at the Harvard Kennedy School. The text of his remarks follows.

Good evening, Harvard! It is an honor and a pleasure to be with you to explore the connection between witchcraft and superstition, on the one hand, and modern central banking, on the other.

I won't spend much time defining terms. Witches, as you know, cast spells, make storms and fly on goats or broomsticks to diabolical nighttime rendezvouses called sabbats. Modern central bankers override the price mechanism, conjure money from thin air and undertake to boost economic growth by raising up stock prices.

I began thinking about witchcraft in the context of central banking a few months ago. The 2012 Republican Party platform pledged a victorious Romney administration to form a commission to study a return to the gold standard. Some commended this plank, others criticized it—and some sarcastically suggested that the Republicans, as long as they were at it, might as well study the revival of witchcraft.

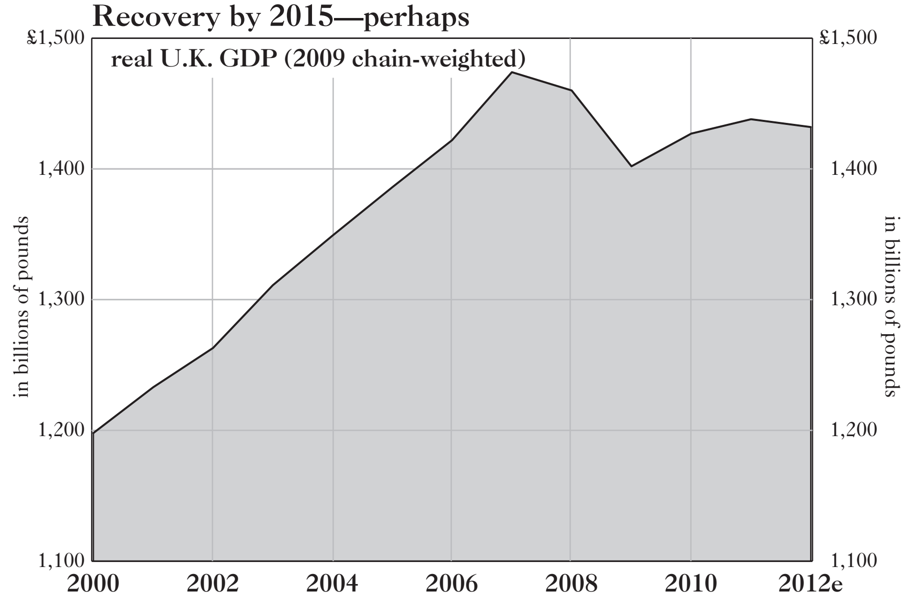
These derisive allusions reminded me of an essay by the British historian H.R. Trevor-Roper entitled, "The European Witch Craze of the 16th and 17th Centuries." In it, Trevor-Roper sends up a warning against the common presumption that the history of thought traces a straight line from the darkness to the light. Far from it, as the historian shows by citing in evidence the outbreak of "dark passions and inflammable credulities" amidst the flowering of the Renaissance.

The belief in witches was not, Trevor-Roper writes, "as the prophets of progress might suppose, a lingering ancient superstition, only waiting to dissolve. It was a new explosive force, constantly and fearfully expanding with the passage of time. . . . Credulity in high places increased, its engines of expression were made more terrible, more victims were sacrificed to it. The years 1550-1600 were worse than the years 1500-1550, and the years 1600-1650 were worse still. Nor was the craze entirely separable from the intellectual and spiritual life of those years. It was forwarded by the cultivated popes of the Renaissance, by the great Protestant reformers, by the saints of the Counter-Reformation, by the scholars, lawyers and churchmen. . . . If those two centuries were an age of light, we have to admit that, in one respect at least, the Dark Age was more civilized."

Hurricane Sandy taught a history lesson to hundreds of thousands of New Yorkers. Waking up in the cold and the dark, they suffered a kind of involuntary time travel. For days on end, they lived as their forebears had only a few generations before. When, at length, the heat and the light and the blessed cable TV connection and Internet service were restored, the unwashed and unshaven storm victims could thank their lucky stars that they live in an age of transcendent material progress.

But not all is well even in this time of plenty. Sovereign governments groan under seemingly unpayable debts. Our Great Recession, though officially ended in 2009, continues to cast its pall over our finances, labor markets and politics. In Britain, the Bank of Eng-

Recovery by 2015—perhaps



source: IMF

land speculates that output will not return to the levels of 2008 until the year 2015 at the earliest. From these manifold troubles, the world seeks deliverance through the techniques of modern central banking.

What the central bankers can do to help is not, in fact, so obvious. We Americans built too many houses and borrowed too much money to buy them. We produced too little and spent too much. A layman might suppose that to set things right a chastened people should work and save. We should mark our errors to market, restructure our debts as necessary and try to do better next time. But the layman would reckon without the theory and practice of modern currency management.

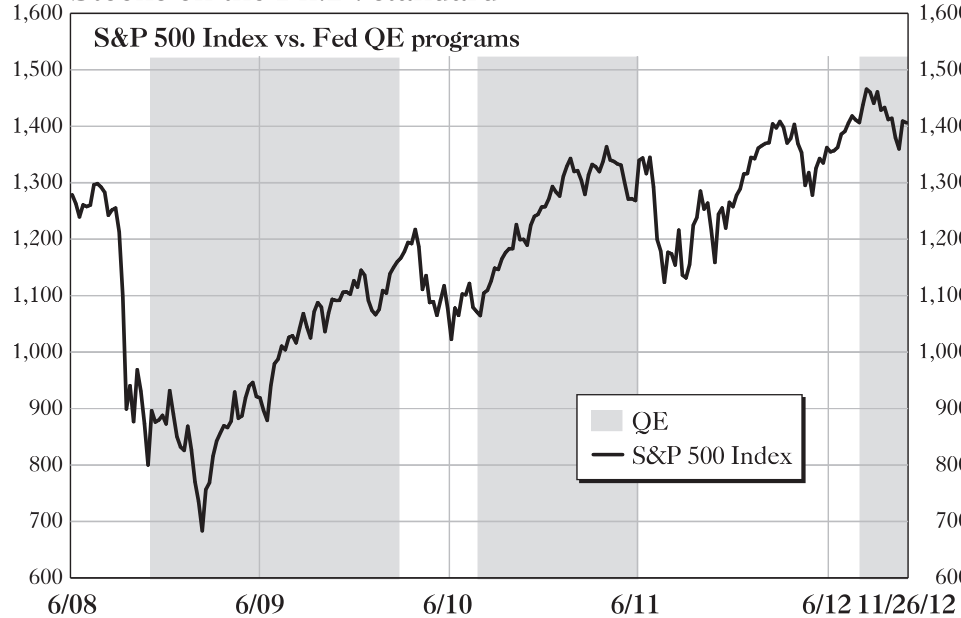
As to the theory, the highly trained economists who fix the interest rates (fix them to the point of invisibility), manipulate the yield curve and buy up hundreds of billions of dollars of notes, bonds and mortgages with newly materialized dollars profess that they know more than the market. That is their credo.

You have probably never heard a fully credentialed monetary economist profess this article of faith in just those words. The mandarins speak a language all their own, half faculty-club English and half mathematical symbols. Just how far up in the clouds are their heads may be inferred from a sample of the research papers recently produced by economists at the Federal Reserve Board:

- "From Many Series, One Cycle: Improved Estimates of the Business Cycle from a Multivariate Unobserved Components Model."
- "A Reliable and Computationally Efficient Algorithm for Imposing the Saddle Point Property in Dynamic Models."
- "Computing Dynamic Stochastic General Equilibrium Models with Recursive Preferences and Stochastic Volatility."

Formidable indeed are the intellects that create the scholarship that supports the Federal Open Market Committee in the business, not so much of central banking, but of a halfway kind of central planning. Press down interest rates by so many basis points and lift up asset prices by so many percentage points, the Ph.D.s at the Fed suggest. Hiring will restart, too, they say. Inflation will twitch higher also, but not by so much and, in any case, the scholars will not forget to reduce the rate of rise in the cost of living when the time is right. The Fed has devised an exit strategy.

Stocks on the Ph.D. standard



sources: The Bloomberg, Federal Reserve

This is no reformed and rehabilitated Federal Reserve. It is the same bureaucracy that somehow failed to notice the coming of the credit storms of 2008, the biggest event, bar none, in the bureaucrats' professional lives. Yet we are asked to believe that the unchastened mandarins will be any more observant come the next cyclical moment of truth.

Once we had the gold standard. Today we have the Ph.D. standard. Central banks in the era of the classical gold standard—that is, in the 40-odd years preceding the start of World War I—employed no economists. They monetized no government securities. They adjusted their discount rates to assure the ease of convertibility of bank notes for gold, or gold for bank notes, at the fixed and statutory rate. The system worked as well as any human monetary contrivance has ever worked.

Then came the guns of August 1914. Came John Maynard Keynes. Came the Great Depression, fascism, communism, statism, World War II, Bretton Woods, today's pure paper dollar—and the thoroughgoing transformation of economics into an outcropping of applied mathematics. Sounding for all the world like physicists, the doctors of economics became central bankers.

Though you can hardly understand a technical word they write, the mathematical mandarins are not physicists. Friedrich Hayek, in a speech given on the occasion of his acceptance of the Nobel Prize in economics in 1974, denounced the scientific pretensions of his fellow economists. Especially did he chide them for insisting that the only magnitudes that matter are the ones you can measure. He called this error "superstition."

Now it happens that the founder of physics, Sir Isaac Newton, was a contemporary of the founder of econometrics, Sir William Petty. Imagine yourself in a London coffeehouse along about the year 1685. You know Newton and Petty. Sharp as a tack, they are. And each is on the threshold of discovery in a promising new field of thought. Imagine now that you have been returned to life. You are informed that the physicists have discovered the God particle, whereas the economists are embarked on QE3, having no real way of knowing if it will do any good—or, for that matter, if QE1 and QE2 worked, either. Plainly, physics has made a different kind of contribution to human society than economics has. Then, again, physics is an easier nut to crack than economics. Electrons don't have feelings, as they say.

Progress in science is cumulative; we stand on the shoulders of giants. But progress in finance is cyclical; in money and banking, especially, we seem to keep making the same mistakes. Just yesterday, the deputy governor of the Norwegian central bank took a swipe at quantitative easing. If Ben Bernanke doesn't watch out, said Jan F. Qvigstad, the chairman of the Federal Reserve will go down in monetary history as the 21st century's own John Law. As you know, Law disastrously over-cranked the money presses more than 300 years ago.

What imbues money with value? The stamp of the sovereign? Or the nature of the monetary medium itself, say gold and silver? The debate is recurrent, perhaps eternal.

Anyway, the case for the gold standard is no anachronism. Those who greeted the gold plank in the GOP platform with a derisive snort perhaps failed to understand the simple elegance of a convertible currency. To use a musical metaphor, the classical gold standard is money in the key of C, the people's key. The Ph.D. standard, in contrast, is money in the key of G-flat, a key for the musicologists.

Say this for the musicologists, they don't exercise coercive power. Central bankers do, but they shouldn't. They don't know enough—can't know enough—to use it wisely, as Hayek observed. "Even if such power is not in itself bad," he continued in his Nobel Prize Lecture, "its exercise is likely to impede the functioning of those spontaneous ordering forces by which, without understanding them, man is in fact so largely assisted in the pursuit of his aims. We are only beginning to understand on how subtle a communication system the functioning of an advanced industrial society is based—a communication system we call the market and which turns out to be a more efficient mechanism for digesting dispersed information than any that man has deliberately designed."

I conclude that the Ph.D. standard, not the gold standard, is the anachronism. In this day of increasing reliance on social networks, we have, in the Federal Open Market Committee, a throwback to the command and control methods of Eastern Europe in the dark age of the 1950s. One might almost call it witchcraft.

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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.

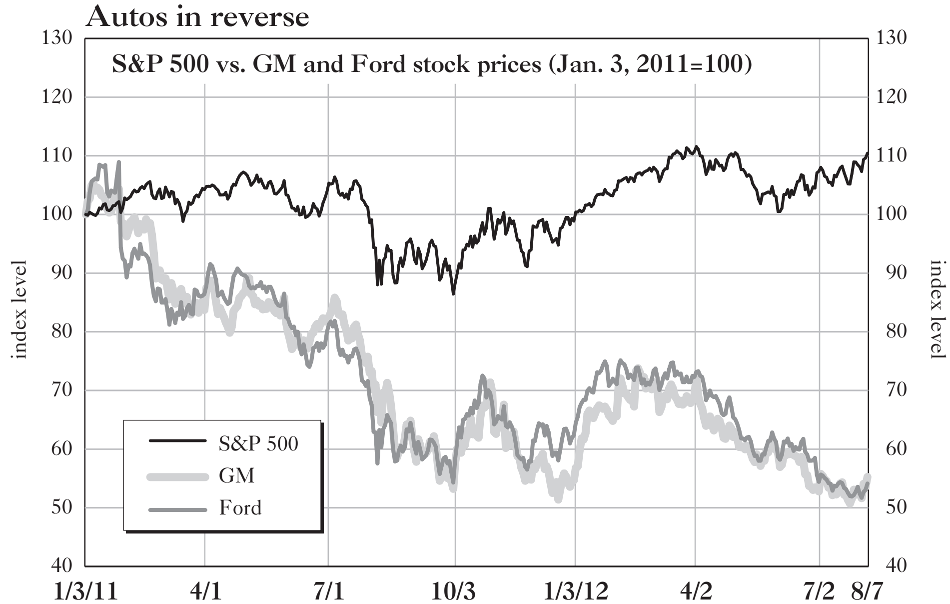
Six weeks after a $50 billion, taxpayer-financed tow into the Chapter 11 garage, however, there emerged the reorganized GM. You could hardly tell it was the same company. Compared to the pre-bankruptcy lemon, "new" GM boasted 40% fewer dealers and $79 billion less debt. It gained a few things, too: wage 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.

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 run-

Autos in reverse

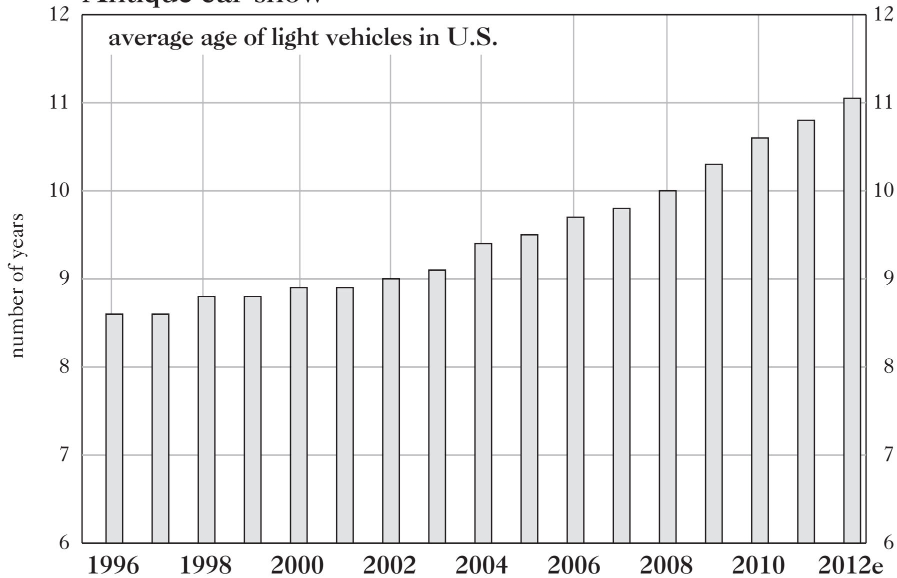


source: The Bloomberg

ning 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.

Antique car show



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

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.

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?

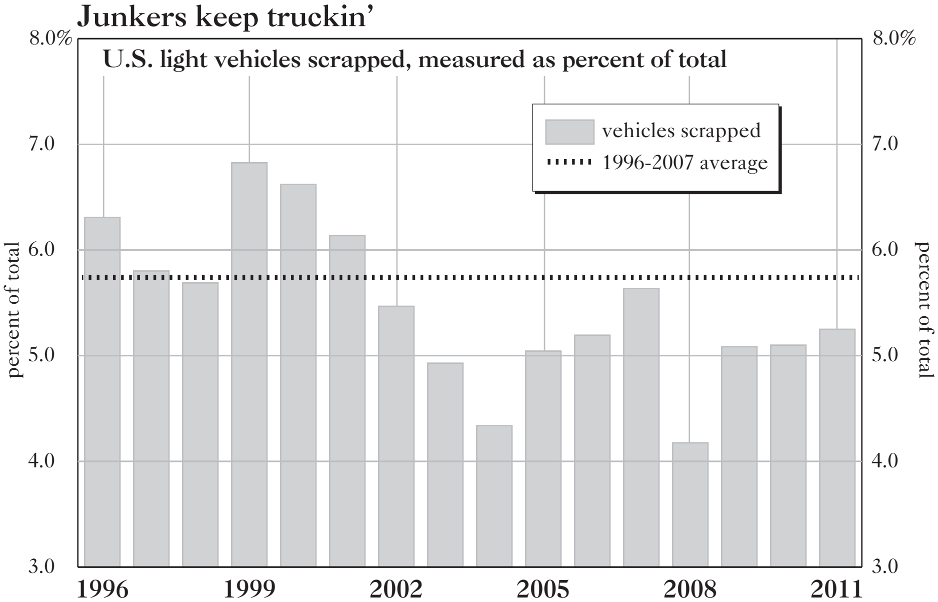
"Our journey starts with our products," the CEO answered, "and I am pleased to report that we are now in the early days of one of the biggest global product offensives in our history. The impact of new vehicles will be especially profound in the United States, where about 70% of our nameplates will be 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.

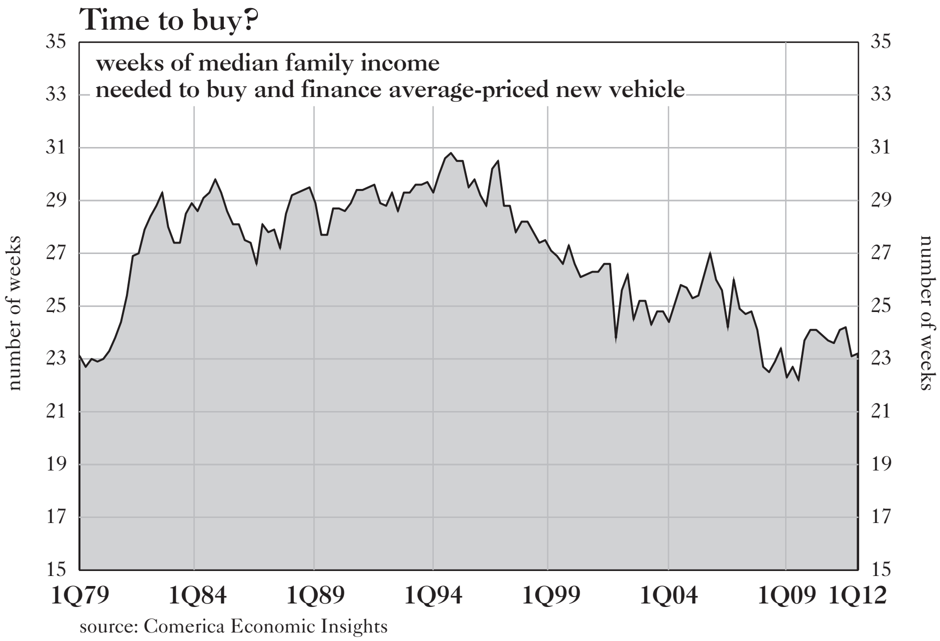
"Something else about new products," Peligal proceeds, "they command better prices than showroom-worn merchandise. Over the five-year life of the typical automobile or truck product line, or—as they say in Detroit—'platform,' years one and two deliver better prices than years four and five. In the second 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."

Junkers keep truckin'



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



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 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.

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.

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