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Desperately seeking income

"Perhaps largely because of the general ignorance of the actual earnings power of the certificates," Benjamin Graham wrote almost a century ago, "Great Northern Iron Ore has always been a favorite medium of market manipulation."

Plus ça change. The price of the shares—GNI on the New York Stock Exchange—makes no more sense today than it did in 1918. What's changed is the identity of the manipulators. It isn't a shadowy "they" who have taken the shares in hand and pushed them to heights where they don't belong. Blame, rather, chiefly attaches to the public servants who manipulate, or—we forget ourselves—"repress" dollar-denominated interest rates.

Now begins another installment in the chronicles of the great yield famine. GNI, priced to deliver a very temporary dividend yield in excess of 12%, is Exhibit A. Junk bonds, sovereign debt and a certain Puerto Rican financial institution comprise Exhibits B through one-loses-count.

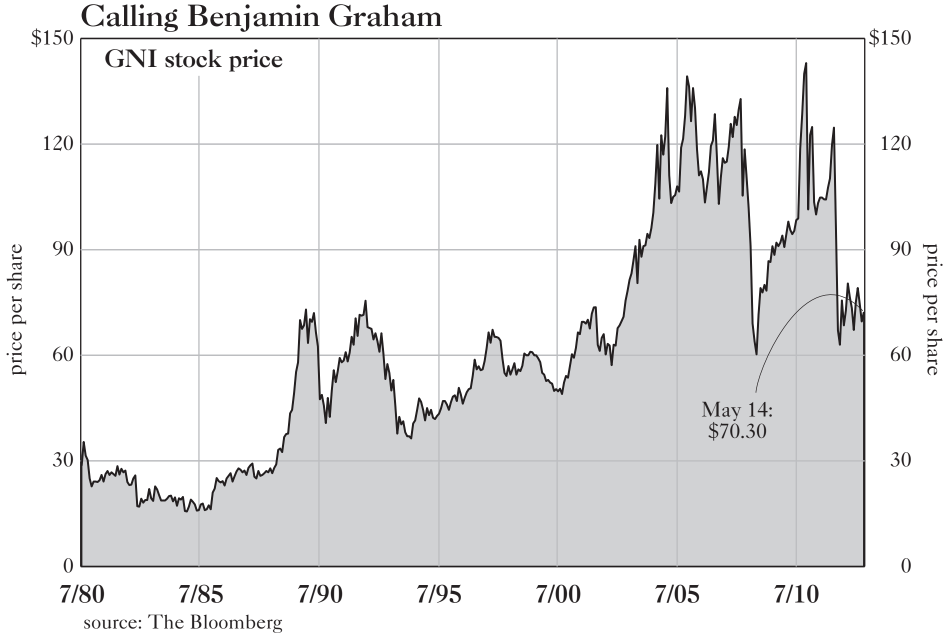
You can search high and low without finding a more transparently mispriced security than Great Northern Iron Ore Properties. At the current price of $70.30 per certificate, the owners will certainly suffer a loss of principal when the company goes out of business on April 6, 2015, as it most assuredly will. Schroder Investment Management, the leading institutional holder with 25,200 shares, according to Bloomberg, will want to pay especially close attention to the following details.

Great Northern Iron Ore was organized in 1906 to exploit the iron ore deposits in the Mesabi Iron Range in northeastern Minnesota. Louis W. Hill, son of the railroad titan James J. Hill, was the founder. Ownership of the mineral deposits would enhance the value of the family railroad, Louis saw. So would the revenue to be earned by hauling the ore to market (a corporate descendant of the railroad is now in the hands of Berkshire Hathaway). As Minnesota state law forbade any corporation from owning more than 5,000 acres of land, Hill organized his venture as a trust.

To quote from the company narrative: "On Dec. 7, 1906, 1.5 million Great Northern Iron Ore Properties certificates of beneficial interest (shares) were issued to the stockholders of the Great Northern Railway, and the Trust was immediately quoted on the New York Stock Exchange. Fifty years later, the restrictive land ownership statute provision was repealed and all of the assets of the liquidated companies were transferred to the direct ownership of the trustees of the Great Northern Iron Ore Companies."

GNI today owns more than 67,000 acres in northeastern Minnesota. From the likes of U.S. Steel Corp. and Hibbing Taconite Co., the company earns income from mineral leases, which it duly remits to the certificate holders. By the terms of the trust, GNI must dissolve on the 20th anniversary of the death of the last survivor named in the 1906 trust agreement. As the last survi-

Calling Benjamin Graham



source: The Bloomberg

vor, Louis W. Hill Jr. died on April 6, 1995, at the age of 92, the money will positively stop on April 6, 2015.

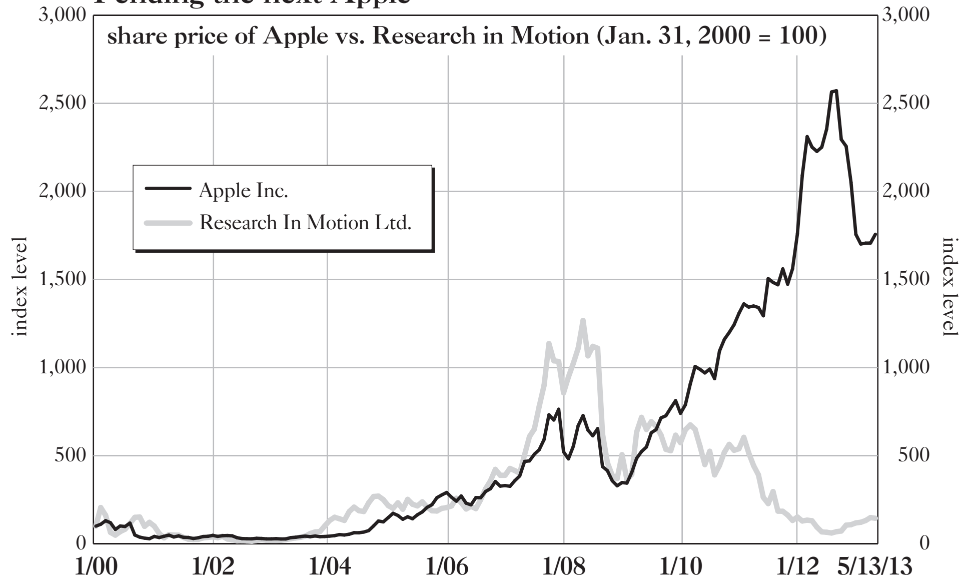
Now, then, what is GNI worth? If assets and liabilities were liquidated at year-end 2012, the company shareholders would have received $8.39 per share, according to company calculations. Colleague Evan Lorenz called to ask management for an updated estimate. The voice at the other end of the phone cheerfully asked if the man from *Grant's* realized that the company was going out of business. "Oh, yes," Lorenz replied. And that was the extent of the information vouchsafed.

"But," Lorenz proceeds, "we can guess. GNI paid dividends of $15 a share in 2011 and $14 a share in 2012. In disbursing $2.25 per share for the first quarter, management warned that 2013 earnings would fall short of the record results of the prior two years. But let us generously assume that the company pays out $13 a share both this year and next, and makes a final dividend distribution of $2.25 a share in the first quarter of 2015. The undiscounted earnings stream plus the aforementioned $8.39 a share in final liquidation value would amount to $34.39 a share, not quite half of the current price of $70.30. You begin to suspect that the investment research of the present cohort of GNI holders begins and ends with a viewing of the page on the Bloomberg terminal that mentions the 12.7% dividend yield."

For any who would sell short this seemingly tailor-made short-sale candidate (market cap: $105.5 million), never mind. Informants tell Lorenz that you can borrow, at most, 200 shares at a cost of $45 per share per year, or 65% of the price. It is good to know, however, that at least the bears are monitoring the situation.

On, now, to desperately-seeking-income Exhibits B through whatever—there are more than enough samples to run through the alphabet. Eircom Group, the oft-dealt Irish phone company that "racked up €4.1 billion of gross debt through five ownership changes in 13 years before filing Ireland's biggest creditor protection petition in March 2012," as Bloomberg put it the other day, last week raised €350 million in seven-year notes yielding $9\frac{1}{4}$% in an upsized deal that was four times oversubscribed. Use of proceeds is the purchase of outstanding bank debt; Moody's rates the notes Caa1,

Pending the next Apple



source: The Bloomberg

meaning, approximately, "good luck with that!"

"The high yield spread," comments Marty Fridson, CEO of FridsonVision LLC, "is too tight relative to economic conditions and credit availability. Currently, the market is like an overstuffed suitcase. If left alone, it would burst open, but its owner, who has bulked up to 300 pounds, is sitting on it and showing no intention of getting off. The question is whether, when the time comes, the Fed will be able to keep the lid shut while at the same time pulling out some of those surplus pants, shirts and undies."

While preparing to perform that parlor trick, the Fed kibitzes. "In light of the current low interest rate environment," the chairman said on Friday, "we are watching particularly closely for instances of 'reaching for yield' and other forms of excessive risk-taking, which may affect asset prices and their relationships with fundamentals." Very helpful.

In the same vein of watchful waiting, the Fed might ponder the anomalous relationship between floating-rate senior bank debt, on the one hand, and fixed-rate junk bonds, on the other. In the nature of things, loans trade richer than bonds, but today's interest-rate markets are slightly unnatural. Thus, relates Bill Housey of First Trust Advisors, Chrysler Group's B1/B-rated bonds of 2019 are priced to yield 3.76% to the worst (i.e., to maturity or the 2015 call, whichever comes first), while the automaker's tradable bank debt yields 5.27% to a three-year life, or 5.46% to the 2017 maturity.

Notable, too, is B1/BB-minus Calpine Corp.'s 2019 term loan, which fetches 4.18% to maturity or 3.35% to a three-year life vs. 3.86% for the comparable Calpine bond. "This is particularly interesting," says Housey, "because the bonds are secured, as are the loans (i.e., pari passu). In the bond, one takes a lot more rate risk for roughly the same yield and same position in the capital structure." Makes sense, we suppose, if one were persuaded that the interest rates aren't going anywhere except sideways or down.

So sell bonds and buy loans? "When you consider that loans have greater seniority, and thus greater recovery prospects in the event of default, plus lower volatility and virtually no rate risk all at a comparable yield, it looks like a no-brainer trade," Michael Kessler, an analyst at Barclays Capital, observes. "The mitigating factor is that loans can be prepaid with virtually no penalty, whereas most high-yield bonds are callable only at fairly material premiums, if at all, until they get close to maturity. We've experienced that already this year with about $150 billion in loans getting repriced, with more to come for sure. The end result is that the stated yield on loans, whether individually or at the index level, winds up being more than what the investor ultimately receives."

The unusual relationship between stocks and bonds could provide the

Fed with another fruitful avenue of research. On April 30, Apple Inc. raised $17 billion of debt in the biggest corporate bond offering on record, and it reportedly could have sold $50 billion. Bond worshippers took down the Apple 2.4s of 2023 at a yield pitched 35 basis points lower than the dividend yield on the iPhone maker's equity.

It goes without saying that technological dominance is a greasy pole. Such humbled giants as Research in Motion, Palm Inc. and Nokia attest to that fact. Apple's talent and treasury may or may not be enough to keep the next Apple at bay.

But, allowing for these risks, what are the chances that Apple's stockholders could earn less over the next 10 years than the holders of the brand-new Apple 2.4s of 2023? "Recall," notes Lorenz, "that Apple has $58 billion remaining with which to purchase its own shares, a mission the company says it intends to complete by year-end 2015. If Apple continued to pay out the same level of dividends and completed the buyback program, the price of a share of AAPL would have to fall by 6.8% over the next decade to match the total return on the 2023 notes. Adjusting for the projected share repurchases, this would imply that Apple's stock-market capitalization would fall by 20% in order for the shares to do no better than to match the return on the Apple 2.4s.

"As it is," Lorenz adds, "Apple changes hands at a free-cash-flow yield of 10.9%. Assuming that the shares went nowhere for the next 10 years, assuming that management completed its buyback and assuming that free cash flow in the next 10 years grew at only half the rate of free cash flow in the past five years, Apple would be priced for a free-cash-flow yield of 145% come the year 2023."

And none of these calculations takes into account the shrinking purchasing power of the dollar. If Apple equity holders are betting on the iPhone and its successors, Apple debt holders are no less betting on Ben Bernanke and his successors. You pick your poison.

Many these days are picking the poison of foreign places—Bolivia, for instance. Last fall, the scenic, private-property expropriating, contract-abrogating and formerly hyper-inflating South American nation issued its first international sovereign debt since 1920. And the Bolivian 4⅞s of 2022 this year have rallied by 57 basis points, "the most among sovereign bonds with BB-minus ratings tracked by Bloomberg." Now the Bolivian state-owned energy company, Yacimientos Petroliferos Fiscales Bolivoanos, a.k.a. YPFB, is weighing another bond sale, and the omens here, too, are favorable, that is, favorable for the borrower. "Bolivia's economy grew 5% last year, almost double the average pace in South America, and helped President Evo Morales achieve a trade surplus. . . ," Bloomberg reports. "While Morales has nationalized at least 17 businesses since taking power in 2006, investors faced with record low yields as central banks suppress interest rates are embracing the nation to capitalize on its energy resources."

Double-B-rated Portugal, too, is locked in the ardent, not entirely discriminating embrace of the world's famished income seekers. The euro zone country that put the "P" in "PIIG" last week raised €3 billion in a 10-year note priced to yield 5.7%. It was Lisbon's first since its massive 2011 bailout. "There is no other market where you can get this kind of yield," Philip Brown, head of sovereign capital markets at Citigroup, was quoted as saying in the *Fin ancial Times*. "We are quite happy," Portugal's debt chief, Joao Moreira Rato, said according to Bloomberg. "We have more than 360 investors and the book was three times oversubscribed."

Not so happy is the bank president who feels the need to characterize the state of his institution as "fragile." But such was the public admission of Javier Ferrer, president of the Government Development Bank for Puerto Rico, according to the May 2 *Bond Buyer*. The GDB, founded in 1948 as the financing arm of the Commonwealth of Puerto Rico, has assets of $15 billion, an $8.4 billion loan book and debt ratings of Baa3/BBB-minus. S&P, which downgraded the bank in March, terms the outlook "negative."

You've heard stories of the banks whose premises are crawling with auditors and examiners from the Federal Reserve, the Federal Deposit Insurance Corp., the Office of the Comptroller of the Currency and, for all we know, the National Park Service. The GDB is not one of those minutely scrutinized institutions. It is audited at 18-month intervals by the Commissioner of Financial Institutions of Puerto Rico, and its president and directors are appointed by the Governor of Puerto Rico.

The gob-stopping word "fragile," it seems, was chosen with the Puerto Rico Highways and Transportation Authority (HTA) in mind. As of Dec. 31, 2012, the GDB had $2 billion of exposure to that single agency, up from $1.3 billion in 2011 and $751 million in 2009 (i.e., the fiscal years ended June 30). Reading the 2012 GDB annual, you sense that the bank and the HTA have become co-dependents. To repay its debts to the bank, the HTA expects to sell bonds, the bank says. And if the HTA can't access even this bond market? In that case, the front office of the bank hopes, "the Commonwealth would provide financial support to HTA to repay its outstanding borrowings with the bank."

Hoping, or perhaps not seeing, the market prices GDB's taxable 4.15% senior notes of August 2017 at 98.64 to yield 4.4%. By comparison, the Bloomberg BBB generic taxable curve yields 3.82% at five years and 4.65% at seven. Perhaps owners of GDB debt expect the bank to police its profligate borrowers. Or maybe investors are awaiting a bailout: in a March 21 note, S&P predicted a "very high" likelihood of "extraordinary support from the government of Puerto Rico in the event of financial distress."

Distress, Puerto Rico already has plenty of. Unemployment tops 14%, while the Commonwealth's general obligation debt rating stands at one notch above junk. The Commonwealth's budget has been in the red for a dozen consecutive years and counting. Maybe what the island territory needs is its very own central bank. Or, then, again, maybe not.

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