GRANT'S

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JAMES GRANT
EDITOR

Happy and Merry

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Sincerely yours,

James Grant

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Sell to whom, Michael Hasenstab?

(July 11, 2014) "Rather go to bed supperless than rise in debt," admonished Benjamin Franklin, spiritual founder of Franklin Resources (BEN on the New York Stock Exchange). The giant mutual fund company has made a fortune for itself and its investors by studiously ignoring Poor Richard's advice. Stewardship of the company's $355 billion in fixed-income investments is the subject at hand.

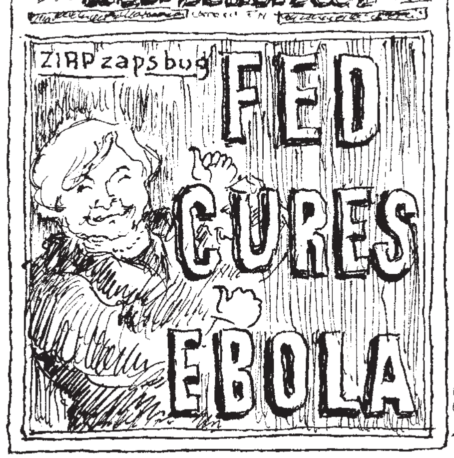
Skipping down to the bottom line, we are bearish on BEN on account of that stewardship. Illiquidity is the glaring fault we identify and document. Admittedly, it's a thesis that may meet with skepticism. Shareholders of the management company and investors in the company's bond funds alike could hardly ask for more than Franklin has delivered.

Since 2001, shares of Franklin Resources have produced a compound annual rate of return of 13.6%, more than double the 5% per annum turned in by the S&P 500 (in both cases, we assume that dividends were reinvested). It's an achievement attributable in part to the extraordinary success of the company's bond funds, notably the flagship Templeton Global Bond Fund. Over the past 10 years, shares of TPINX have returned 9.2% a year compared to 5.3% served up by the average global fixed-income portfolio.

Forty-year-old Michael Hasenstab is the star behind the stellar returns. Best Global Manager (Standard & Poor's/*BusinessWeek*, 2006), Top U.S. and Global Bond Fund Manager (Bloomberg, 2009), Global Bond Manager of the Year (*Investment Week*, 2010), Hasenstab first joined Franklin Templeton in 1995. Following a leave of absence to study at the Australian National University (he earned a Ph.D. in economics), he rejoined the firm in 2001.

Few of Hasenstab's many accolades are likely more bankable than the five-star rating Morningstar confers on the Templeton Global Bond Fund for superior 10-year, risk-adjusted returns (as measured by the so-called Sharpe ratio, about which more presently). Thus credentialed, Hasenstab oversees $190 billion in fixed-income investments, 80% of which are held by four big funds, foreign and domestic versions of the aforementioned Templeton Global Bond Fund and the Templeton Total Return Fund. Altogether, Hasenstab is responsible for 20% of total company AUM and the substantial income those assets produce.

"Management fees on the Hasenstab funds range from 50 to 75 basis points per year," colleague Charley Grant relates, "while the industry average for global fixed income was 57 basis points in 2013, as measured by Lipper Inc. Only global equity, at 60 bps, earned a higher industry average fee. Fifty-seven basis points on $190 billion comes out to $1.08 billion in annual fee revenue. Then there are sales and distribution fees—asset-based fees for BEN accounted for $1.7 billion, 20% of which amounts to another $340 million; adding that to the aforementioned $1.08 billion gives you $1.4 billion. At a 50% margin, we are talking about a $700 million contribution to the bottom line, nearly a third of the $2.2 billion that BEN booked in trailing 12-month net income." If Hasenstab isn't the perpetual Franklin Resources Employee of the Month, we'd like to know who is.



How does he do what he does? "What gives you comfort to pull the trigger on an investment?" an interviewer from *Barron's* asked the portfolio manager in a June 7 Q. & A. To which Hasenstab replied, "It's the feeling in the pit of your stomach when you are questioning yourself and everyone else thinks you are wrong. If we are confident in the fundamentals and the team has ripped it apart, that's usually a good check that we are doing the right thing. If it's really easy and everyone is in agreement, it's probably not." Which *Grant's* reader could quarrel with that?

Is there anything else that might explain these outsize returns? "The vast majority of our assets," Hasenstab told the *Financial Times* last month, "are in deep liquid markets that we can move in and out of with ease—Japanese yen, Korea, Mexico, Poland, Canada, Australia, Sweden—and then we opportunistically rotate through special distressed opportunities." Morningstar echoes Hasenstab's self-assessment. The famous Morningstar style box rates the flagship Global Bond Fund "medium" in the article of credit quality; "limited" is the verdict on duration risk (and a good thing that would be if interest rates ever did turn up).

It's on the points of liquidity and concentration that *Grant's* parts company with BEN's boosters and joins the evidently small circle of its critics (we so judge by the small short interest in Franklin Resources common). The fact is that the Hasenstab-managed funds are heavily exposed to assets that could be sold only with difficulty.

Hasenstab—who, through a Franklin Resources spokeswoman, declined to come to the phone—readily acknowledges that some of his holdings are illiquid. They are conservatively counterbalanced with perfectly liquid ones, he contends. After analyzing his four major portfolios, position by position, we respectfully disagree.

What does "illiquid" mean? There's no hard and fast definition. To some risk managers, days to exit a position is the relevant criterion; if you need a month of trading days, assuming that your selling represents a conservative percentage of the assumed daily trading volume, that position would likely be judged hard to escape from. Percentage ownership of a given issue is another risk-management criterion. If you yourself own a commanding share of a certain issue, you yourself become the market. How can you objectively price the security? (You can't.) How could you easily sell it? (You couldn't.)

To the Securities and Exchange Commission, an illiquid asset is one "which may not be sold or disposed of in the ordinary course of business within seven days at approximately the value at which the mutual fund has valued the investment on its books." The commission ruled in March 1992 that such assets may constitute no more than 15% of a mutual fund's portfolio.

"By regulatory lights, then," Grant observes, "the U.S. Templeton Global Bond Fund, with $72 billion in assets as of the end of May, should have no more than $10.8 billion in illiquid securities. Let's see about that.

"As of the Feb. 28 semiannual report, when the fund reported $69 billion of net assets," Grant continues, "TPINX disclosed large holdings of Hungarian bonds—sovereign debt worth $4.9 billion as well as a $262 million position in the Hungarian Development Bank. These positions, denominated primarily in the local forint (euro-denominated holdings were roughly $717 million), amounted to 7.5% of the portfolio. Bonds issued by the government of Poland, primarily denominated in the local zloty, summed to $7 billion—10.1% of the portfolio. An additional 4.6% of net assets were held in Ukrainian bonds—$3 billion in sovereigns and another $216 million in state enterprise infrastructure bonds. Again, these bonds were denominated primarily in the local hryvnia. The three positions alone constitute 22.2% of total portfolio assets. It seems like a pretty illiquid portfolio already, before we debate the marketability of bonds issued by South Korea (14% of the portfolio), Ireland (10%), Malaysia (7.1%), Brazil (4.7%), Indonesia (1.8%), Slovenia (1.2%), the Philippines (1.2%), Russia (1%) and Serbia (0.8%). U.S. money-market investments represented 14.2% of the AUM."

When illiquidity came up as a topic for discussion at the May 22 investor-day question-and-answer session, Hasenstab brushed it aside. "Oftentimes," said the portfolio manager, "a few of the positions kind of may be interesting to talk about or write about and so those get a lot of attention. [B]ut when you look at the whole portfolio and take Ukraine, for example, it's less than [a] 5% position. Eighty percent-plus of the portfolio is in deep liquid markets that we could move billions within minutes, if not hours."

Not so according to survey data on trading activity collected by the Trade Association for the Emerging Markets. Hungary, a double-B credit, makes a case in point. According to EMTA, euro bonds with a face value of $9.7 billion and local debt with a face value of $17 billion changed hands in the first quarter for a total of $26.7 billion. As there were 61 trading days in the three months, $438 million was the average daily volume. If Franklin could sell at a rate of 15% of the average daily turnover, the position would take 79 days to liquidate. If Hasenstab could somehow achieve 50% of daily average volume, an exit would take place in 24 days.

"We find a similar story in Ukraine, where $51.6 billion in par value traded in the first quarter," Grant goes on. "Again, we will count euro bonds, which accounted for slightly more than a third of this volume, although just $62 million of Hasenstab's $3.2 billion is euro-denominated. Counting all debt, average daily volume was $845 million—which would take 25 days to liquidate at 15% and 7.6 days at 50%. Counting local debt only, average trading volume would decline to $540 million; one would need 39 and 12 days to sell, assuming 15% and 50% of daily volume, respectively. Repeat the process with the $7 billion, A-rated Polish position, nearly all of which is, or at least was as of the statement date, zloty-denominated. Reported volume of $66.3 billion (local currency volume was just $48 billion) works out to an average daily volume of $1.1 billion. Under the 15% and 50% assumptions, that's 43 and 13 days to exit, respectively.

"Holdings in even relatively developed markets are large enough to potentially pose a problem," Grant proceeds. "South Korea, for instance, is a fairly rich country with a weak double-A local currency credit rating. EMTA reported $42.4 billion of total first-quarter trading volume. Under our now-familiar assumptions, average daily trading volume was $696 million, which implies 93 days to exit at 15% of average daily volume and 28 days to exit at 50%

Illiquidity: an assortment
holdings of Templeton U.S. Global Bond Fund

	market value	% of portfolio	avg. daily Q1 volume	——days to exit—— 15% daily vol.	50%
Hungary	$5,188	7.5%	$438	79	24
Malaysia	4,966	7.1	831	40	12
Poland	7,082	10.1	1,087	43	13
Ukraine	3,231	4.6	845	25	8

sources: company reports, Trade Association for the Emerging Markets

Templeton U.S. Global Bond Fund
top 10 holdings

Issuer/coupon/maturity	market value (in billions)	TPINX holding (% outs.)	size of 2nd-largest holding
Ireland 5 Oct. 2020	$2.3	31.8%	1.6%
Poland 6.25 Oct. 2015	1.8	28.1	2.6
KMSB* 2.76 June 2015	1.7	36.5	0.5
Poland 5.5 April 2015	1.5	24.8	2.1
Ireland 5.4 March 2025	1.2	17.0	0.4
Sweden 4.5 August 2015	1.1	0.2	-
Poland 4.75 Oct. 2016	1.1	6.9	-
Hungary 6.375 March 2021	1.0	62.3	2.3
KMSB* 2.9 Dec. 2015	1.0	11.1	0.4
Ireland 5.9 Oct. 2019	0.9	15.1	0.4

*Korea Monetary Stabilization Bond
sources: company reports, the Bloomberg

of average daily volume. Turning to A-rated Malaysia, EMTA found a total of $50.7 billion in first-quarter trading volume (we will include the $4.5 billion worth of euro bonds, which do not appear in this portfolio). Using the same procedure as before, we find an average daily trading volume of $831 million. At 15% of average daily volume, Hasenstab would need 40 days to sell, at 50% of the volume, 12 days."

The preceding pertains not to the entire Hasenstab-managed complex but to the U.S. Templeton Global Bond Fund alone, which represents only 38% of Hasenstab's AUM. TEMGINI, the Luxembourg version of the Global Bond Fund with $38.6 billion under management, holds $3.4 billion in Hungarian, $2.8 billion in Polish and $1.4 billion in Ukrainian bonds. Then, too, Hasenstab's funds hold positions in Ghanaian debt, both dollar- and cedi-denominated; local currency bonds have a par value of 1.5 billion cedis ($465 million). Bloomberg posts no prices for the relevant cedi-denominated securities. According to EMTA, $1.6 billion traded in the first quarter for an average daily volume of $26 million. A would-be seller would require the patience of a saint.

How might Hasenstab have defended his M.O. if he had chosen to speak up? Possibly to object that the EMTA volume data are no more reliable than most survey-derived statistics. What he actually did say—this was at the May investor day—is that "when you talk about volatility, I think it's important to talk about volatility [of] the whole portfolio. The global bond portfolio volatility is basically in line, [if] not often lower than U.S. Treasurys."

To which colleague Grant rejoins: "This statement belies one of the problems with the Sharpe ratio as a performance appraisal tool. The Sharpe ratio assumes that returns follow a normal (i.e. bell-shaped) distribution. For infrequently traded instruments, such as many of the bonds examined in this story, a normal distribution assumption could be considered inappropriate—emerging-market investments are characterized by negative skew-ness (meaning the left, or negative, tail of the distribution is longer than the right). The majority of observed investment outcomes might be positive, but the potential exists for sharply negative returns in any given period. Moreover, the absence of frequent transaction data leads to an understatement of the volatility of returns, not to mention the opportunity for acute pricing error. The 'risk-adjusted' returns of the Templeton Global Bond Fund look terrific, but Dr. Hasenstab might just find that entering into his chosen positions was easier than getting out."

You can infer as much by examining the individual holdings. The nearby table enumerates the top 10 positions of the U.S. edition of the flagship Templeton Global Bond Fund as of May 31. Hasenstab must love his positions; he apparently won't let anybody else near them.

"No analyst gets a CFA charter for pointing out that assets under management are likely to fall at mutual fund companies during market panics," Grant points out. "It is, however, worth noting that withdrawals do happen, even in the absence of a panic—and even in the absence of poor performance. Pimco's Total Return Fund, for instance, has suffered 14 consecutive months of outflows, reducing its assets to $225.2 billion from $293 billion before the exodus began. 'The Total Return Fund, long lambasted as underperforming, is outperforming its index by a decent margin,' a defensive-yet-fatalistic Bill Gross was quoted as saying by the *Financial Times*, 'and yet to complain and to whine, we're $50 billion poorer over the last 13 months. It makes you wonder why that would be.'"

What advice might we have for investors in the Franklin Templeton's star-spangled bond funds? Only that, in any future rush to liquidate, it would be better to be early than late. And for the Franklin Resources' stockholders, a question: Are you quite sure you know what you own?

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Banking on India

(April 4, 2014) On average, the Indian stock market—the topic of the travelogue in the prior issue of *Grant's*—is neither cheap nor dear. The heart of the investment narrative is rather revealed in the valuation peaks and valleys.

Now in progress is an exploration of the opportunities in a market that's already rallied and might just continue to rally. Perhaps Narendra Modi, the great white hope of India's business and financial community on the eve of what the Indians call their "dance of democracy," one of the world's largest and longest and most prodigiously financed national elections, will become the prime minister who unclogs the stopped-up Indian economy. From the *Grant's* observation tower in lower Manhattan, the situation seems hopeful. How might a foreign investor lay down a few well-placed chips on one of mankind's forever-latent growth stories?

For the casual American individual, the choices are plain vanilla: an open-end mutual fund, the Matthews India

Fund (MINDX), which is managed in San Francisco; the closed-end India Fund (IFN), which is managed in Singapore and trades at a 10% discount to net asset value; and a pair of India-themed exchange traded products, iPath MSCI India Index (INP) and Wisdomtree India Earnings (EPI). The market caps of the four funds sum to all of $2.6 billion, which works out to $2.17 for every Indian man, woman and child.

It's slim pickings for any who would do his own stock picking. Professionals can register with the Securities and Exchange Board of India, apply for a license and, in the fullness of time, expect to win permission to operate locally (much as they can do in South Korea). Without going to the trouble of registering, the investor's choices are restricted to the few big-cap stocks for which American depository receipts or global depository receipts are listed. HDFC Bank, ICICI Bank, Infosys, Wipro and Tata Motors constitute the heart of the individually accessible Indian equity universe.

Is that all? Not quite. India Capital Fund, a Mauritius-domiciled, London-based partnership managed (and co-founded) by Jon Thorn, is an alternative. No index-hugger is he; India Capital, which welcomes qualified investors of the long-term, quiet, contrary, uncomplaining, patient, unleveraged, *Grant's*-reading type, has an outsize position in Indian financials.

"This is a situation that will not last," says Thorn of the self-imposed isolation of Indian finance. "The Indian market will open up more and is doing so, but they have no interest in global day traders, and I tend to agree with them."

It seems to us that investing in India is like planting a tree. Buy a sapling, dig a hole, water and prune. Do not—repeat, not—yank the tender growth from the ground to examine the progress of its root formation. Nature and sunlight willing, trees grow. Politics and ideology willing, societies prosper. The bullish macroeconomic argument with respect to India is that better politics and a less corrosive ideology are in the works, come what may in the springtime elections. It's a view to which we subscribe, though we have no notion of when the payday will arrive—possibly, our grandchildren will collect.

Or, just maybe, our children. "A staggering 814.5 million Indian citizens are eligible to vote in the forthcoming elections," advises Thorn and his team, "and significantly, there are now over 23 million electors in the 18- to 19-year age group, compared to 5.3 million in 2009. India's demographic profile has a political dimension as well as its lauded economic one."

Value-minded investors pride themselves on tuning out the macroeconomic theme music to focus on a microeconomic margin of safety. "Good things happen to cheap stocks" is a mantra that gives good service whatever the political backdrop of the society in which securities happen to change hands. What are the values in India?

"If you compare the valuations right now with the five-year averages and 10-year averages," Sunil Asnani, co-manager of the Matthews India Fund, advises colleague David Peligal, "we're still slightly below the average. If you look at trailing price-to-earnings ratios, it's about 16.3 times for the S&P BSE 100 index [i.e., the Bombay Stock Exchange 100 Index]. And if you look at the five-year and 10-year averages, it's 17.5 and 17 times, respectively. So it's slightly below the five-year and the 10-year averages. If you look at price-to-book, it's about 2.3 times. For the BSE 100, the five-year average is 2.7 times and the 10-year average is 3.1 times. So if you think about valuations historically, it is slightly below, not a lot below."

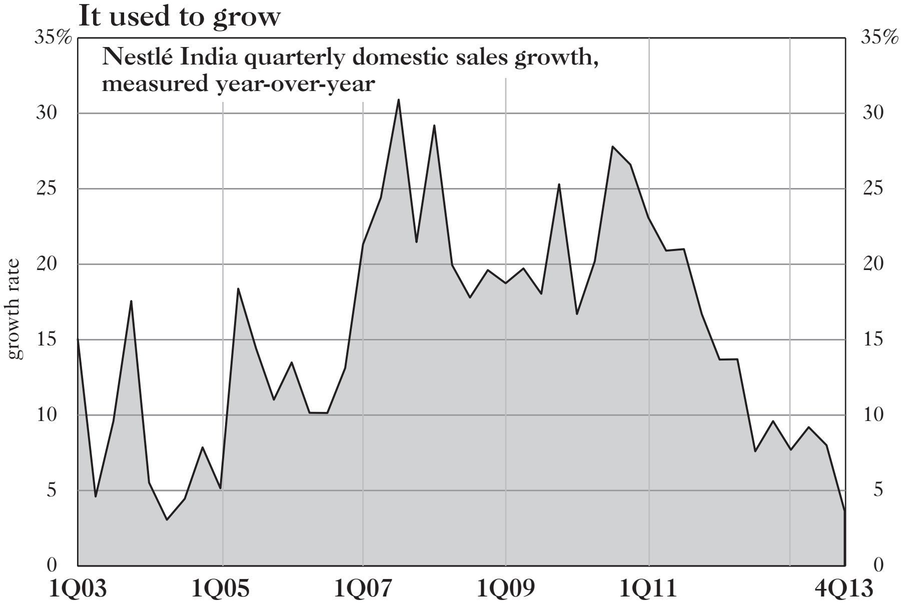
So say the averages. Thorn, whose preferred India market metric is the Sensex index (30 component companies to the BSE's 100), observes that the Indian stock market is anything but a monolith. There are the companies that are valued as if the Sensex were quoted not at today's 20,000, but at, say, 40,000. And there are companies that trade as if the index were quoted at 10,000.

"It's an extraordinary bifurcation between some really expensive, 'safe' companies like Nestlé India, and a whole bunch of other companies, including banks, which are really historically cheap, excluding the global financial crisis," says Thorn. "So if you look outside the main banks, which are trading at 2.0 to 2.5 times book, you can find banks that are trading materially under book.

"If you assume anything except the worst case and a reasonable adjustment to the growth in nonperforming loans," Thorn goes on, "it's really hard to see how they're not going to go up a lot. On earnings and P/Es, you have banks at seven to nine times, and credit growth this year is expected to be around 14%. So they will disperse 14% more loans than they did a year ago. What you've got is valuations representing, in some cases, extremely negative and difficult credit conditions, with, nevertheless, extraordinarily good—compared to the rest of the world—credit growth. It's not extraordinarily good vis-à-vis India, but it's still pretty good."

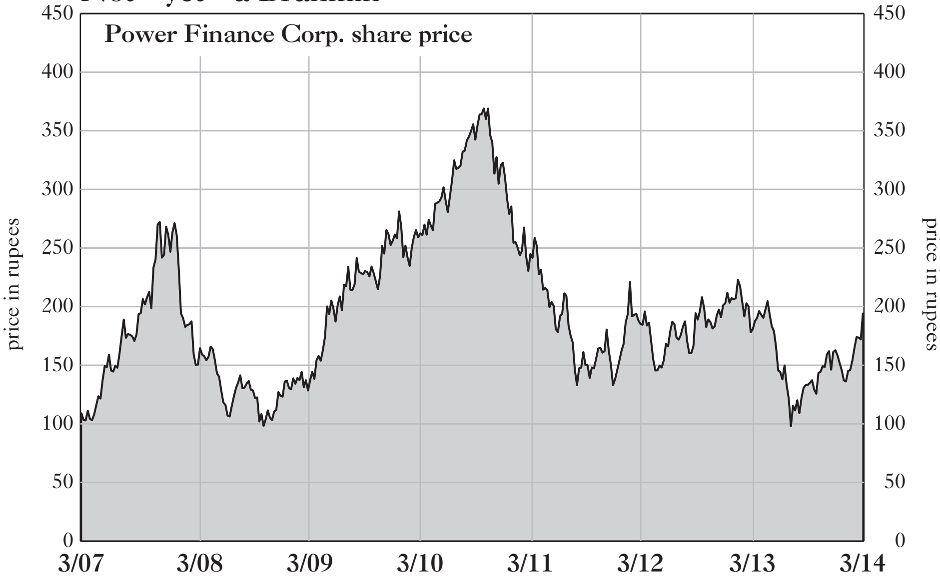
Indian stocks operate in a kind of caste system. Consumer products' companies are among today's equity-market Brahmins. To the international Graham-and-Dodd diaspora, it's puzzling just why this is so. Prices of such basic inputs as wheat, coffee, skim milk powder,

It used to grow



source: IDFC Securities Ltd.

Not—yet—a Brahmin



source: The Bloomberg

palm oil, vinyl acetate monomer and high-density polyethylene have been on the hop, crimping sales and margins.

In consequence, relates the Indian brokerage house Prabhudas Lilladher in a March 24 note, "Companies have increased prices of detergents, toilet soaps, skin care, paints, malted food drink and oral care by 3% to 6%, which will delay recovery in volume growth, given sustained inflation and poor consumer sentiment. We believe sector valuations will continue to correct either by way of absolute correction in stock prices or time corrections." Be that as it may, Nestlé India, which in February disclosed its lowest quarterly domestic sales growth in 10 years, trades at 35.7 times the consensus sell-side estimate for fiscal year 2014 net income and 30.7 times the fiscal 2015 estimate.

In response to Peligal's question—why?—Amnish Aggarwal, one of the authors of the Prabhudas Lilladher report, kindly e-mailed: "Valuations are still sustaining as India is being seen as a long-term consumer growth demand story. In fact, most bullish are global funds."

Not every global fund is bullish in just that headlong, high-P/E fashion. Thorn's fund, which he helped to establish in 1994 and which has delivered a 6.3% compound annual return over the 20 years (compared to 4.4% per annum for the Sensex), is one exception. To disclose an interest, Thorn is a paid-up subscriber to this publication, and his inimitable chairman, Marc Faber, is a past speaker at *Grant's* events. Certainly, the principals' refined taste in financial journalism reflects well on their fund. We are drawn to something else. India Capital, which charges a 1 1/4% per annum management fee and takes 20% of the earnings above a 5% hurdle rate, is out on a limb and says it means to remain there.

The limb on which the fund is perched is a banking and financial services' limb; half of its $220 million in assets are allocated to those allied businesses, $2^1/_2$ times the weighting to banks and finance in the Sensex. Thorn contends that India's banks are in better shape than they seem and that the country's well-ventilated asset-quality problems are less severe than many analysts believe. Perhaps the bearish analysts are remembering 2013 rather than anticipating 2015; last year, Thorn's fund, heavily laden with financials, was down by 21.7%, compared to a 3.5% loss for the Sensex.

A meaningful portion of nonperforming loans are traceable to India's dysfunctional regulatory system, Thorn says. Loans to the energy and power industries, specifically, are hostage to bureaucratic delay. It's a problem that a strong reforming hand at the top of the Indian government might set about fixing—Modi's hand, for instance.

In India, there's a great divide between banks in which the government owns a majority interest (the result of a past nationalization) and the ones in which it holds no such interest. State Bank of India is the prototypical government-controlled institution, HDFC the quintessential private kind. Entrepreneurial and light on its feet characterizes only one of the two kinds of Indian bank, and HDFC is that kind.

You, gentle individual-investor American reader, could buy HDFC on your own, if you chose (it is accessible as a New York-listed ADR). You could not independently purchase other favorites of Thorn's, including IndusInd Bank Ltd. (IIB IN on Bloomberg) or Power Finance Corp. (POWF IN on Bloomberg).

Power Finance, 74% owned by the government, is one of the stocks that is valued as if the Sensex were closer to the recent lows than to an all-time high. Based on Thorn's 2015 projections, the shares change hands at four times' earnings and 90% of year-end 2013 book value; they yield 6%.

"The company makes 20% of all the power finance loans in India," Thorn tells Peligal. "For example, if you're one of these power projects, or even, in some cases, a power distributor, you'll take a loan from the Power Finance Corp. PFC will usually be the lead lender on any power project. Any project that PFC does not lend on will be a tricky loan to get done, because the other lenders will look to PFC—and they have a couple of thousand specialists working for them—to give a lead in terms of, 'Is this project feasible, doable, quantifiable in terms of money and time?'"

Operating under the sovereign umbrella, PFC is a low-cost lender, Thorn adds. For the same reason, it tends to get repaid. Then, too, "you're almost guaranteed top-line growth, because they're lending into a fast-growing sector, i.e., power projects."

Peligal pressed Thorn for the bear story; no company trading at four times the estimate is without one. Thorn replies that the market is worried about credit stresses. It is concerned that, in case of a meltdown of the rupee, PFC's foreign borrowings would become crippling (though the currency has rallied by 15% from last summer's lows). Finally, some fret that the government will coerce the company into lending against bad projects for political reasons. "So far it has not done this," Thorn says. "Why would it start now?"

"I recently had a meeting with one of my ex-investors," Thorn says in conclusion, "and he gave me a 35-page report from Credit Suisse saying how the Indian banking system is going to hell and back—and actually wasn't coming back at all without a lot more capital. I sat there and told him that all this was completely wrong. There are plenty of people out there who will tell you radically, diametrically the opposite story to our view. I think our investors, who have suffered with having 50% exposure to banks when nobody wanted to own banks—everyone wanted to own software, pharma and consumer staples (we don't own any of these)—our investors would say to us, 'When will the banks start to work?' And our answer is that they never stopped working, it's just that nobody has noticed. So the question we often get is, 'Why do you have this extreme portfolio allocation?' And the simple reason is that it's the best and cheapest growth in the market. Where else can you go to find something at four times earnings trading for less than book and yielding more than 5%? Those are not the characteristics of Blue Dart Express [at 52 times the estimate]—never have been, never will be."

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FedEx's little friend

(June 27, 2014) Monmouth Real Estate Investment Corp. (MNR on the New York Stock Exchange) is a small REIT with a big dividend. Its story—featuring growth in e-commerce, the widening of the Panama Canal and the gift of scrawny interest rates—is the subject under discussion. To jump the gun, we're bullish.

"Fiscal 2014 was a good year for Fed Ex," Alan B. Graf Jr., FedEx Corp.'s executive vice president and chief financial officer, was quoted as saying in the company's June 18 earnings release, "and we expect fiscal 2015 to be even better." Monmouth, owner of industrial warehouse space that fits the age of digital retailing to a "t," not surprisingly sees the future in much the same cheerful vein as FedEx does. Some 42% of Monmouth's gross leasable space is tenanted by FedEx, including 28% by FedEx Ground, the domestic, truck-borne segment of Fred Smith's global delivery service.

There was evidently no such business plan when Monmouth went public in 1968. The future CEO of the future FedEx was 24 years old, there was no e-commerce and the 10-year Treasury fetched 5.65%. Monmouth, founded by the father of the REIT's two currently serving senior officers, built and leased industrial real estate, pure and simple.

Forty-six years after its founding, Monmouth commands an equity market cap of $530 million and enterprise value (add debt and preferred to equity and subtract cash) of slightly more than $900 million. Considering the relatively large number of years and the relatively small sum of dollars, you may wonder what the business has been doing with itself all this time. No need to wonder about the past decade, though. Since June 2005, Monmouth shares have generated a total return of 128%, or 9.6% per annum. They have outperformed not only the MSCI US REIT Index, which has appreciated at an annual rate of 7%, but also the equity of the mighty FedEx, which has delivered but 6.6% a year.

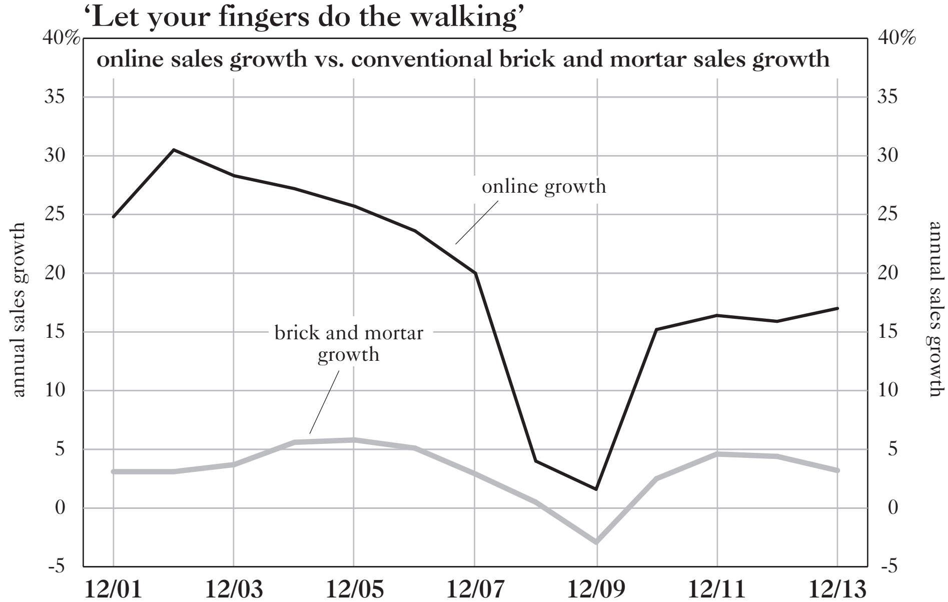
Monmouth's letter to shareholders in the 2013 annual report, co-written by Eugene Landy, chairman of the board, and Mike Landy, president and CEO, talks about "our longevity in the cyclical asset class of commercial real estate." It mentions the company's unusual specialty in "single tenant, net-leased industrial properties on long-term leases to investment grade tenants." And it adds this: "When you purchase a share of stock in our company, you are effectively purchasing a fractional interest in the real estate that we own and manage. We do not have any off-balance sheet joint ventures. We do not have a development division, and we do not carry a large amount of non-income producing land on our balance sheet. What we do have is simply one of the best quality industrial property portfolios available in the public arena today."

As for Monmouth's diminutive size, observes colleague David Peligal, "let's just say that management has been very methodical about its business strategy. Since it focuses on long-term, net-leased industrial properties, leased overwhelmingly to investment-grade tenants, it has necessarily been picky. In addition to FedEx, the roster includes Anheuser-Busch, Coca-Cola, Home Depot and Sherwin-Williams. This results in high-quality income streams that are reliable and predictable over the long term. During the credit crisis, Monmouth's occupancy never dipped below 95% and its dividend was never cut." Today's dividend yield towers at 6.3%.

Industrial REITs, like the office-building kind, are beneficiaries of the post-crisis drought in construction. Industrial REITs, unlike their office brethren, are heirs to the growth in direct-to-customer retailing. E-commerce sales may represent no more than 7% of U.S. retail turnover, but they're growing at double digits. "The contrasting results of Cyber Monday and Black Friday in 2013," according to a CBRE report on U.S. industrial real estate from May, "illustrates the degree to which e-commerce is changing the retail landscape and consumer behavior. Cyber Monday online sales totaled a record $2.3 billion, up 21% from 2012. Meanwhile, sales on Black Friday saw their first decline since 2009, dropping 2.9% compared to 2012."

Monmouth's warehouse assets, which

'Let your fingers do the walking'



sources: CoStar Portfolio Strategy, U.S. Department of Commerce are concentrated in Texas, Florida and up the eastern seaboard, may also stand to gain from the expansion of the work that Teddy Roosevelt thought was finished a century ago. "With the expanded Panama Canal, set for completion in the second half of 2015," Mike Landy tells Peligal, "we're going to see a wider array of our ports handling the goods flowing in and out of the country. Overall demand for industrial space will increase as a result of this because the Canal expansion represents a major enhancement to the entire global supply chain. The global supply chain will become less dependent on our western ports, which are increasingly becoming a bottleneck. We're going to see more goods moving through the Gulf of Mexico and up the eastern seaboard as the expanded Canal comes online. This will especially benefit Monmouth given our geographic footprint."

The inventory of American industrial warehouses measures 12.8 billion square feet. It would surely be larger today except for the post-crisis credit brownout. As a rule, industrial construction responds quickly to changes in business conditions; start to finish, the construction cycle spans 12 to 18 months. Over the past five years, warehouse capacity has shown average growth of 50 million square feet a year. To accommodate economic growth and building obsolescence alike, more like 150 million square feet a year would have been needed.

Then, again, pinched supply supports rising rents. While industrial rents nationally have risen by only 50 cents from the 2011 bottom, to a little under $5.50 per square foot, the next couple of years may smile on the landlords. "Clearly," Peligal observes, "upon lease renewal, you can generate rent growth, and 10% of Monmouth's assets roll each year. In addition, Fed Ex is expanding a lot of properties, and that expansion results in additional lease term and higher rents."

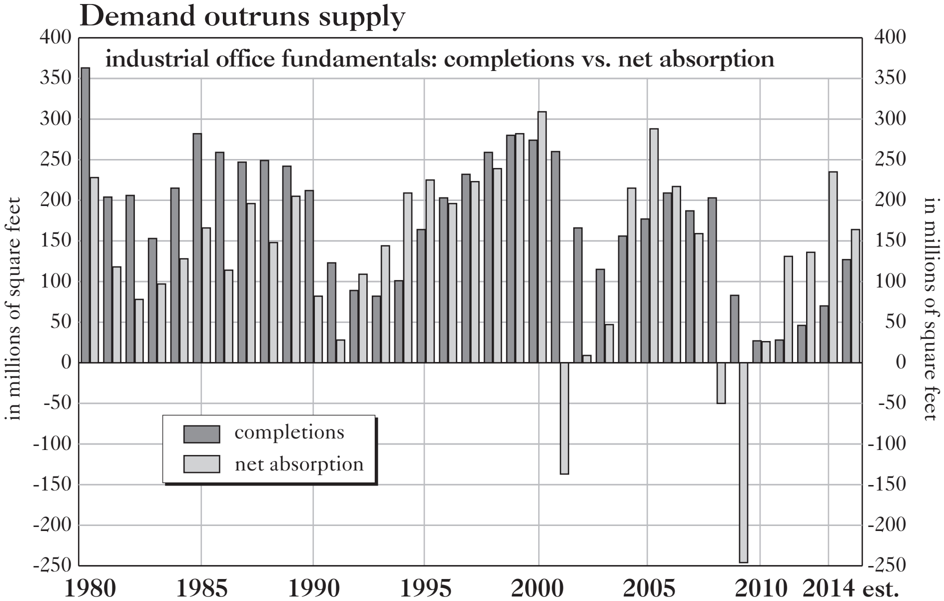
Peligal asked the CEO for his thoughts. "While industrial is known to be a slow grower as far as same-store growth in net operating income," Landy replied, "what's good about industrial is the stability of the income streams. You tend to have lower volatility in occupancy and earnings, and therefore very predictable income streams. But the biggest point going forward is that we're not building shopping centers and we're not building malls in the U.S. anymore. Consumer spending, the lion's share of our nation's economy, is migrating from Main Street to cyberspace and we're seeing tremendous demand for industrial properties as a result of this secular shift. It's a game changer if ever there was one. Therefore, looking at rental-rate trends in the past is not as relevant in considering the potential increases going forward. Going forward, the bigger driver in total returns may not come from the income component but in the rise in property values. Commercial real estate is known to be one of the best safe harbors in an inflationary environment and with the industrial property sector becoming the new retail sector, we are anticipating appreciation well in excess of inflation."

Landy, 52, who succeeded his father at the head of the company early in 2013, is bringing a zest for growth to the job. In the five years ended in 2015, Monmouth expects to have doubled its size through the acquisition of brand-new, Class A, build-to-suit properties. As might be imagined, investing in net-leased industrial properties is very much a yield spread business.

Peligal asked about interest rates. "In our first quarter of fiscal 2014, which began on Oct. 1, we did $74 million in new acquisitions," Landy said. "Our average cap rate was 7.4%, while the average interest rate was 3.95%. So we were getting a 345 basis-point spread. A 345 basis-point spread is highly accretive, and it enabled us to grow our earnings per share by 26% year-over-year. We've been at this for 46 years, and I can tell you that over that period the normal range is a 200 basis-point spread. The normal numbers, historically, are you borrow at 6%, you invest at 8%, resulting in a 200 basis-point spread. Now, interest rates have recently been going back up and cap rates have continued to come down, and therefore investment spreads have contracted accordingly. However, because Monmouth has approximately $222 million in new acquisitions under contract that we'll be closing over the next six quarters, we have been able to lock in a 270 basis-point spread thus far. While this is not the substantial 345 basis-point spread we saw in the first quarter, it is still 70 basis points above the historic norm, and it is still highly accretive."

Debt was the next item on the agenda: Peligal invited the boss to extoll his balance sheet. "On each individual new acquisition, we can apply 65-70% leverage," Landy replied. "Because these loans are fully amortizing, usually over a period of 10 to 15 years, coupled with the fact that many of our existing properties are owned free and clear, Monmouth's overall leverage is only 30%. It's a very holistic approach to financing our assets in this way, as we're paying down $30 million to $35 million in principal every year, and we're ending up with properties that we own free and clear. We have been building up our unencumbered asset pool as the ratings agencies like to see a substantial amount of gross assets unencumbered. With 87% of our revenue derived from investment-grade

Demand outruns supply



source: CBRE Econometric Advisors

tenants, one of our goals is to achieve an investment-grade rating ourselves."

It's a winning story, but Monmouth trades at a discount. The symbiotic relationship with FedEx is one reason why. Size introduces a host of other difficulties: The shares trade only a few million dollars' worth a day, research coverage is sparse, the weighting in the MSCI US REIT Index is low, etc. "Monmouth's 6.3% dividend yield is not just high," Peligal observes, "it is shockingly high given the excellent quality of Monmouth's assets. Prologis (PLD on the NYSE) trades with a 3.2% dividend yield, Duke Realty (DRE on the NYSE), at a 3.8% yield. STAG Industrial (STAG on the NYSE), a $1.5 billion market-cap company, is perhaps most similar to Monmouth since it also focuses on single-tenant, net-leased industrial properties. STAG, which went public in 2011 and whose top 10 tenants account for only a little more than 16% of its net operating income, trades at a 5.5% dividend yield.

"A bull on Monmouth must hope that FedEx, or at least the Monmouth-FedEx relationship, never steps in front of a bus," Peligal winds up. "Then, again, management owns roughly 15% of the company. In a yield-starved world, and with the perception of the company slowly starting to change (as evidenced by that 26% surge in earnings growth), Monmouth might be getting a little better with age."

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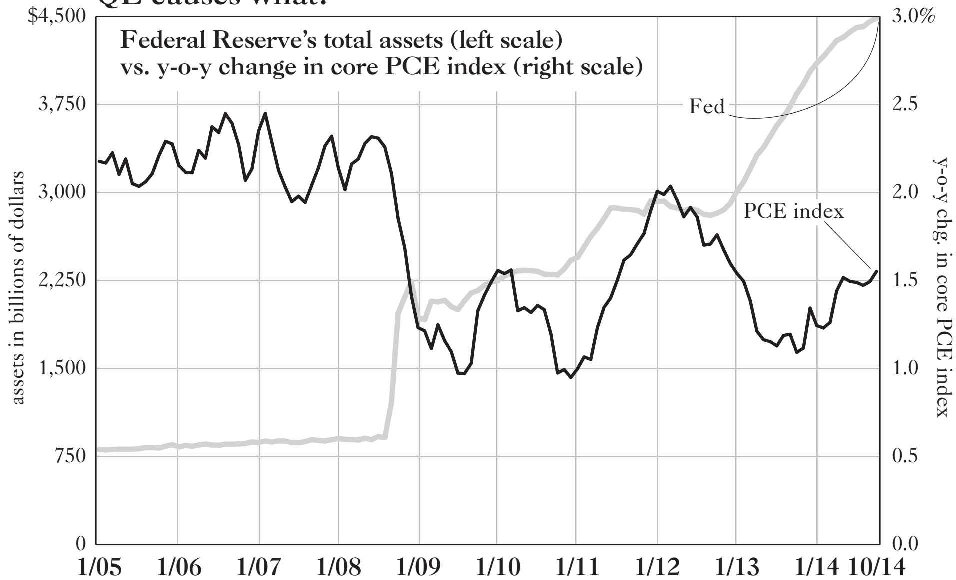
QE causes what?



source: The Bloomberg

One last gasp for Treasurys?

(January 10, 2014) In his valedictory to the nation's economists in Philadelphia last week, Ben Bernanke reiterated his commitment to a price level that never falls but always rises: a rate of 2% a year would be nice, the chairman affirmed. That sentiment, made familiar by years of repetition, scarcely raised an eyebrow, let alone a controversy. It's a deficit we undertake to correct. To put the conclusion ahead of the argument, the Fed will discover—we all will discover—that nothing's so unstable as a stabilized price level.

As we read the new year consensus of investment sentiment, people love stocks, hate bonds and feel sorry for gold. "In the many years I've been surveying experts for their predictions for the coming year," writes *New York Times'* columnist James B. Stewart, "I cannot recall another time when optimism about the stock market, the economy and corporate profits was so widespread. As is pessimism about the bond market."

Perhaps the trader's maxim applies: "If it's obvious, it's obviously wrong." If so, it may behoove us, aged and grizzled bond bears, to imagine a contrary scenario. We ground these imaginings in a longstanding *Grant's* theme, namely, there ought to be deflation.

There ought to be inflation, too, this publication has maintained at intervals since the dawn of QE. Let us rather now focus on the march of progress—and on the accretion of debt. As technology advances, prices should fall. As it costs less to make things, so it should cost less to buy them. In the case of TV sets, washing machines, refrigerators, cell phones, etc., prices have been falling for years. Not since 1996 has the durable goods' segment of the personal consumption expenditures price index registered a positive year-over-year change.

Debt, like progress, is a force for deflation. Encumbered firms produce to remain solvent. Heavily encumbered firms overproduce. Overproduction presses down prices. Easy access to debt prolongs the life of marginal firms. They don't go broke but, finding ready access to speculative-grade credit, carry on, thus adding to the physical volume of production and therefore to the overhead weight on prices. Debt is deflationary the more it drives production, or—in the case of governments and individuals—the more it constricts consumption.

Money printing is inflationary. It lifts some prices, but in the current cycle, not all of them. Banks have been impaired. Borrowers have been reluctant. The dollars that the Fed has conjured, most of them, take the shape of unmobilized bank reserves. They are inert.

The central bank is egging on inflation with one hand but suppressing it with the other. It materializes the dollars that drive some prices higher. It fosters the debt formation that presses certain other prices lower. What it refuses to do is let markets clear.

Since December 2007, the Fed, the People's Bank of China, the European Central Bank, the Bank of Japan and the Bank of England have collectively materialized the equivalent of $8.9 trillion. The five central banks have inflated their balance sheets to $15.1 trillion, or to 20.6% of global GDP, from $6.3 trillion, or 11.1% of world GDP in December 2007. Yet measured rates of inflation have dwindled. In neither the euro zone nor the United States will the rise in the chosen price indices in 2013 (stocks, bonds, commercial real estate, etc. not included) hit the central banks' 2% target.

"Anxieties are rising in the euro zone that deflation—the phenomenon of persistently falling prices across the economy that blighted the lives of millions in the 1930s—may be starting to take root again as it did in Japan in the mid-1990s," reported Monday's *Wall Street Journal*. The deflation bulletin shared page A2 with a dark ponderation on the threat of "secular stagnation," another homage to the 1930s.

As for us, we find the 1920s more instructive. Between 1922 and 1927, wholesale commodity prices fell by 0.1 percent a year, while the cost of living rose by 0.7 percent a year. In that time of hurtling technological progress, one might have expected prices to fall, as they persistently fell in the final quarter of the 19th century. The Federal Reserve was happy to take credit for the fact that they didn't. The central bank seemed to germinate enough credit to resist the gravitational pull on prices of falling production costs and rising productivity. "Business and prices have both become more stable," asserted a Herbert Hoover-sponsored volume entitled, "Recent Economic Changes" in 1929. "There is evidence that our economic system is moving in this direction."

"Price stability" was the ideal, agreed Irving Fisher, professor of economics at Yale University, and Benjamin Strong, governor of the Federal Reserve Bank of New York. Fisher, hugely influential, contended that there was no such thing as a "business cycle"; price disturbances were rather to blame for booms and busts. Iron out the price level and you've conquered the "cycle," he—and many luminous others—contended.

There's more than an echo of Fisher in the words and deeds of our 21st-century mandarins. One notable difference is how the moderns define stability. For Fisher, "stable" meant just that, neither inflation nor deflation. For Bernanke and Yellen and the rest, "stable" means no deflation. To prevent what earlier ages took as a sign of progress—bargains are good, the primitives reasoned—the leaders of the Fed, like their forebears of the 1920s, have had to create enough credit to prop up the price level.

"The world is a cornucopia," this publication observed in the issue dated Jan. 14, 2005. "Thanks to the infernal machine of American debt finance, the Internet and the economic emergence of India and China, among other millennial economic forces, goods are superabundant. More and more services, too, are globally traded, therefore cheaper than they would be in the absence of international competition. Yet the measured rate of inflation in the United States is positive, not negative, as it was in so many prior eras of free trade and technological progress."

At the time we wrote, house prices were rising by 13% and the "core" personal consumption expenditures deflator was rising by 1.6% (both measured year-over-year). Household debt was expanding by 9.7%, personal disposable income by 2.1% (also measured year-over-year). The fed funds rate was quoted at 2.29%, up from 1.27% in November 2002, when the then-Governor Bernanke gave his famous speech about the bogeyman from the 1930s. "Deflation: Making Sure 'It' doesn't Happen Here," he entitled this effort.

Exactly how the former Princeton economist intended to lift average prices without distorting certain, very specific prices—house prices, for instance—he didn't say. Nor did he stop to define terms. That job fell to us, as follows: "Inflation is not 'too many dollars chasing too few goods.' Pure and simple, inflation is 'too many dollars.' What the redundant dollars chase is unpredictable. In recent months, they have chased stocks, commodities, euros, junk bonds, emerging-market debt and houses."

As for "deflation," what it isn't, we said, is falling prices. That is a symptom of the thing, not the thing itself. We defined deflation as too few dollars chasing too much debt: "Dollars extinguish debt; too few dollars in relation to the stock of debt is the precondition for what, these days, is euphemistically called a 'credit event.'"

In a debt crisis, people throw assets on the market to raise cash. The weight of this new supply, not offset by new demand, broadly sinks prices. *That*, to us, is deflation. If, on the contrary, prices fall because the world is becoming more efficient, we would call that circumstance "everyday low prices," or "progress." In no public utterance of which we're aware has any senior Fed official addressed this critical distinction. We had our hopes for the chairman's goodbye address, but the old professor let us down.

Whatever the source of deflation, the central banks of the world are pledged to resist it—by the means

of creating more debt. They are not fighting fire with fire. They are fighting fire with gasoline.

Bloomberg on Monday was out with the projection that debt as a percentage of the world's 34 largest economies (i.e., members of the OECD) will climb to 72.6% in 2014 from 70.9% last year, and from 39% in 2007. In addressing the economists in Philadelphia, Bernanke defended the radical policies of the past five years by alluding to the depression that wasn't and the recovery that is. He failed to mention that the means to the end of salvation was the near doubling of the world's debt burden. Nor did he choose to acknowledge the truism that debt and deflation go together like PB and J.

If the Food and Drug Administration were monitoring Bernanke's speeches, as maybe it should, the Federal Reserve's anti-deflation pledge would include some frank talk about side effects. "People who take QE or ZIRP may suffer from giddiness and a loss of financial perspective," the FDA-mandated disclaimer would say. "They may experience nausea, shortness of breath, hair loss, impotence, bankruptcy and heartburn."

The Fed's price stabilization program is no one-off policy. It's the very mission of the modern central bank. Committed to stabilizing some prices, the Fed is reciprocally (though tacitly) dedicated to distorting others. In the 1920s, an economist at the New York Fed devised a price index encompassing real estate prices and security values as well as rents, wages and wholesale prices. The Carl Snyder Index of the General Price Level rose by 2.7% a year between 1922 and 1929. An updated edition would certainly present a very different picture of today's "stability" than the indices that omit asset prices. Inflation is where the central bankers aren't looking for it.

It strikes us as not a little ironic that a central bank under the leadership of a supposed historian of the Great Depression lives in ignorance of the decade preceding the Great Depression. The best of the contemporary postmortems of the years 1929-33 harped on the unintended consequences of artificial price stability.

"Banking and the Business Cycle," produced in 1937 by the trio of C.A. Phillips, T.F. McManus and R.W. Nelson is the gold standard of the genre, to our mind. As the book is long out of print, we'll quote from it; the authors seem almost to be addressing the editor and the readers of *Grant's*. "The principal shortcoming of price level stabilization as a primary goal of monetary policy," Phillips et al. write, "is found in the fact that the 'freezing' of any one set of prices tends to establish resistances to the readjustments that need to be made continually within the price system if that system is to be kept in balance in the face of a highly dynamic economic setting: stabilization of *all* prices is, of course, quite impossible in any nation other than one having a completely 'frozen' economic structure. Nor is an unchanging price level any insurance against depression, as the events of recent monetary history have abundantly proved."

The authors go on to enunciate a law of unintended consequences. They don't use the word "bubble," but you can tell what they're driving at. "As long as economic progress is maintained," they continue, "resulting in increasing productivity and an expanding total output, there will be an ever-present force working for lower prices. Any amount of credit expansion which will offset that force will find outlets unevenly in sundry compartments of the economic structure; the new credit will have an effect upon the market rate of interest, upon the prices of capital goods, upon real estate, upon security prices, upon wages, or upon all of these, as happened during the late boom. A policy which seeks to direct credit influences on *any* single index, whether it be of prices, either wholesale or retail, or production, or incomes, in the interests of stabilization, will result in unexpected and unforeseen repercussions which may be expected to prove disastrous in the long run."

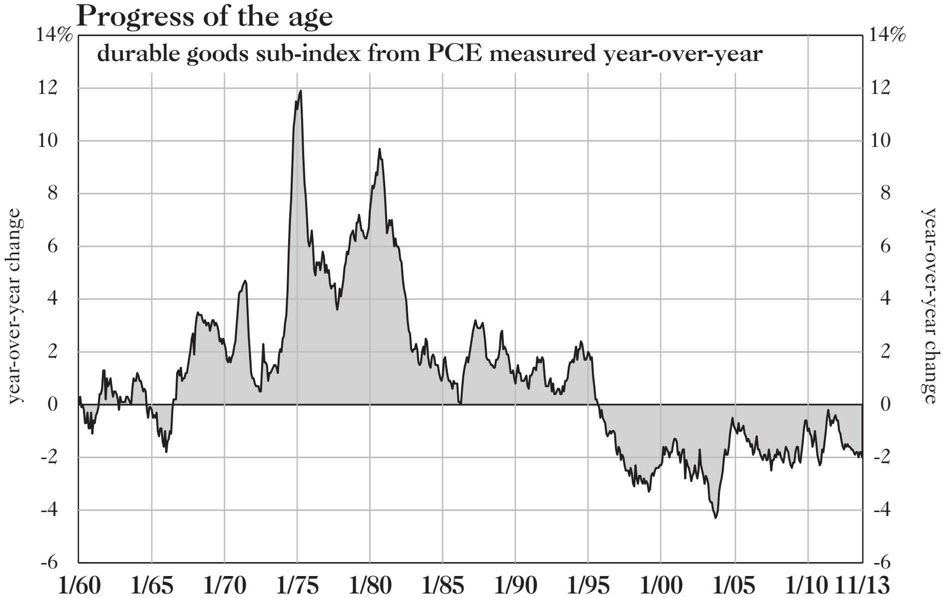
"Disastrous" grabs the reader by the collar; "long run" rather loosens the grip. How to apply the preceding ideas in the here and now?

By resisting deflation, today's central bankers will ultimately create one, we believe. But when? Before or after they instigate an unscripted 3% or 5% inflation rate? We don't know, nor do they.

At last report, November's, the PCE expenditure index registered a year-over-year rise of 0.9%. It's not so far-fetched to imagine monthly readings below the zero marker—there were seven of them in 2009. In five consecutive months between 1961 and 1962, there were year-over-year readings of less than 1%. In 12 consecutive months between 1954 and 1955, there were year-over-year readings in the CPI of less than zero. Nobody seemed to object very much in 1954-55 or in 1961-62. For that matter, the deflation of 2009 could be explained away by the financial crisis (that, actually, was deflation). But now? A more than passing slip into official deflation territory would send the Fed to general quarters. Then what?

Action, of course. The Bank of Yel-

Progress of the age



source: Bureau of Economic Analysis

len is as constitutionally incapable of inaction as were the Banks of Greenspan and Bernanke. The Fed would paw around in its tool kit. It would discover new, seemingly sharper-edged instruments—nominal GDP targeting, perhaps, or some literal application of the Bernanke helicopter-money metaphor.

How would the world interpret an admission of the failure of monetary policy to prevent this imagined lurch to deflation? We suspect it would buy Treasurys. Maybe the government securities market has another big rally in it, and maybe that hypothetical rally will reward this year's contrarians.

Where would all this lead? If we were writing the script, it would lead to a belated but well-reasoned loss of confidence in the institution of modern central banking. It would produce a flight from paper money into tangible things. That is, it would lead to inflation. We expect that it will. And we expect that come that historic moment, people will stop feeling sorry for gold.

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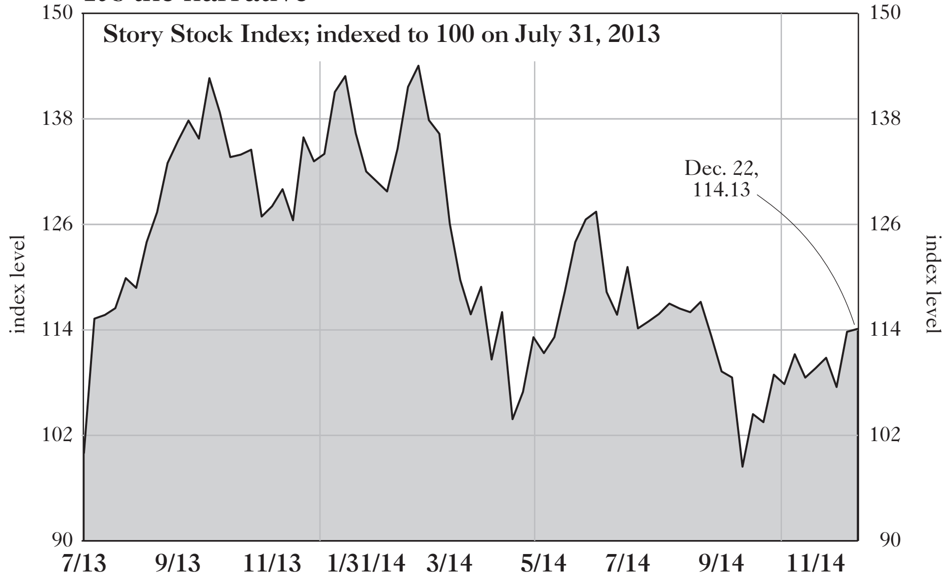
It's the narrative



source: The Bloomberg

Introducing the Grant's *Story Stock Index*

(November 15, 2013) No bull stock market is complete before the debut of the kind of equity that's valued on the quality of its narrative. It's the anticipation of earnings, not their actual arrival, that sets the speculative heart fluttering in the late stages of a proper levitation. "The road is better than the inn," wrote the immortal Cervantes centuries before the Twitter IPO.

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

"One hundred dollars of earnings 10 years in the future are worth $38.55 today if discounted at 10%," CFA Lorenz reminds us. "At a 5% discount rate, they are worth $61.39. But at a zero-percent rate, they are worth $100—and would be worth that much from here to eternity."

So while each of the 15 component companies in the *Grant's* Story Stock Index has its own story to tell, the unifying theme is ZIRP.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Story Stock Index
(in $ millions)

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

*non-financial years
source: The Bloomberg

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

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

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

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

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

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

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

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

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

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

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

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So close to the sun

(January 24, 2014) Jeff Bezos has set out to create the "everything" store. Unfinished though that universal quest may be in the narrow retailing sense, it's a *fait accompli* in the grand, monetary sense. On the one hand, Amazon's zooming share price is a study in asset inflation. On the other hand, Amazon's margin-crushing, bookstore-demolishing, customer-pleasing merchandising strategy is a visible source of price deflation.

In the age of QE, Amazon is the everything enterprise: fire and ice in a single ticker.

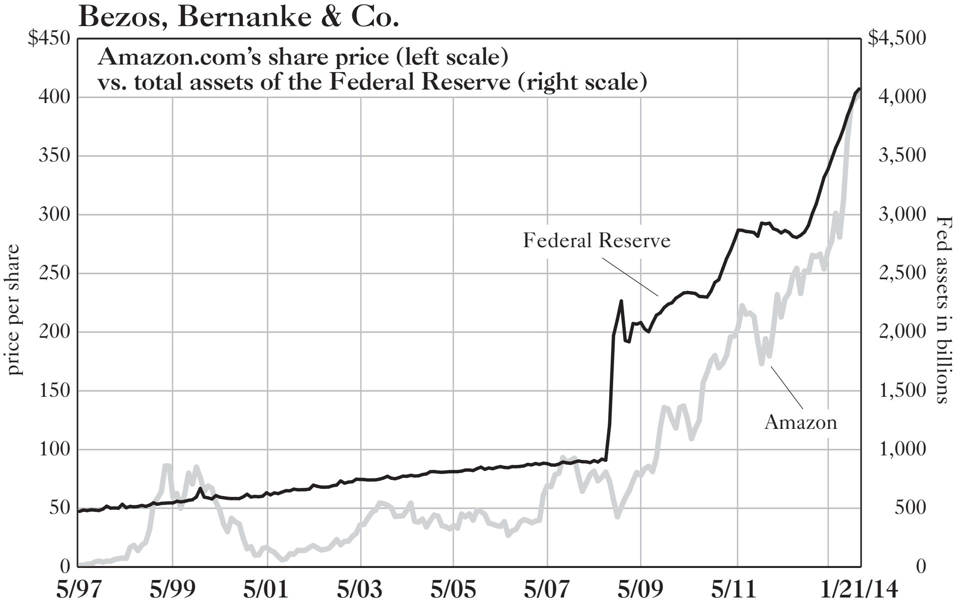
Now under way is a rumination on the effect of the Federal Reserve on Amazon, and of Amazon on the Federal Reserve. It's a coda to the page one story in the previous issue of *Grant's*. As you may recall: Prices should be falling in a time of technological wonder, or so we contended. If it costs less to produce things (and services, too), it should cost less to buy them. Today's monetary authorities move heaven and earth to resist this benign tendency. Deflation is an "ogre," declared Christine Lagarde, managing director of the International Monetary Fund, at the National Press Club last week. Just what grudge she holds against everyday low prices, Lagarde didn't say. Whatever it is, she would probably get an argument from Bezos and his customers alike.

The trillion-dollar question is whether the central bankers will wind up getting more inflation than they bargained for. We note that, according to the Conference Board, global labor productivity growth decelerated in 2013 for the third consecutive year and that, in the United States, the capacity utilization rate for December rose to 79.2%, the highest in five years. What kind of inflation do the bureaucrats wish to raise up? In America, both kinds: the stock-market variety to foster the confidence that leads to a faster pace of consumption and the check-out-counter kind to protect against a return to the economic environment of "The Grapes of Wrath." The Feds are shooting for a rate of rise of 2% a year in consumer prices. They don't disclose the rate of rise they prefer for stock prices. Whatever it is, they seem to be hitting it.

Amazon has to figure among the central bank's warmest friends and worst enemies. To any who preach the gospel of the "portfolio balance channel" (rising asset prices lift all boats, supposedly), AMZN, the share price, is a thing of beauty. It just goes up. The Bezos shares change hands at 1,454 times' trailing net income and 50 times' enterprise value to EBITDA, which is to say earnings before interest, taxes, depreciation and amortization. Amazon's stock-market capitalization stands at $186.3 billion. Not one of the 47 security analysts who follow the company rates it a sell, according to Bloomberg; 11 have the temerity to say "hold." To declare an interest, your editor is a limited partner in a fund that's short the stock.

Ben Bernanke, a great one for the portfolio balance channel, could hardly ask for more, though, perhaps, he hopes for more. As it is, the Dow Jones Industrials change hands at 16 times earnings. Collectively, they command a $4.7 trillion market value. If all traded at the Amazon multiple, the 30 would sell for $459.1 trillion, or six times more than annual worldwide GDP. Just think of the latent spending power in that bit of portfolio balance channeling, the outgoing chairman might ruminate.

Bezos, Bernanke & Co.



source: The Bloomberg

Attendees at the annual convention of the National Retail Federation in New York last week were rather ruminating on their own survival. According to a Jan. 15 dispatch by Lydia DePillis in the Bezos-owned *Washington Post*, the hottest ticket at the conference was a lunchtime briefing about Amazon. People were sitting on the floor and standing in the aisles, DePillis relates, and she quotes the speaker, Lee Peterson of WD Partners, thus: "If you don't think Amazon is a problem for your business, I don't care where you are in the world, you are wrong, you are living under a rock. It's time to come out."

What's to be frightened of? "Nothing," a grateful Amazon customer might reply. "The most predatory aspirational monopolist since John D. Rockefeller," a Best Buy executive, alluding to Amazon's founding genius, might counter. "Deflation," a scholarly Federal Reserve economist might quietly interject (economics being a science and scientists being coolly impartial, supposedly).

Open before us is a copy of "The Everything Store," by Brad Stone, a 2013 book about Amazon. Reading it—and it is a pleasure to read—one was not surprised by Friday's news that Amazon has filed a patent for something it calls "anticipatory package shipping." The point of the invention seems to be that there's no sense waiting for the customer to order when you already read the customer's mind.

Like Sam Walton, the founder of Wal-Mart, and Jim Sinegal, the progenitor of Costco, Bezos strives to amaze and delight the consumer. Since people like to save money, Bezos has built a business around the concept of savings: savings of time, money and aggravation. He has deployed shopping bots, robots, apps, warehouses and warehousemen in the service of low prices. So doing, he has made some not unimportant incremental contribution to thwarting the Fed in its pursuit of its peculiar definition of "price stability." Stone reports on business meetings during which Bezos makes "a big show of keeping one chair open at the conference-room table 'for the customer.'"

The stockholder is virtually present at these gatherings, too, if we read Stone correctly. This is so because,

Amazon.com Inc
(in $ millions)

	2012	2011	2010	2009	2008	2007
Accounts receivable	$3,364	$2,571	$1,587	$988	$827	$705
Inventory	6,031	4,992	3,202	2,171	1,399	1,200
Accounts payable	13,318	11,145	8,051	5,605	3,594	2,795
Working capital	(3,923)	(3,582)	(3,262)	(2,446)	(1,368)	(890)
As percnetage of sales	-6.4%	-7.5%	-9.5%	-10.0%	-7.1%	-6.0%
Days sales outstanding	20	20	17	15	16	17
Days inventory	48	49	44	42	34	38
Days payable	106	109	111	108	88	89
Cash cycle	(38)	(41)	(50)	(51)	(38)	(33)
Cash from operations	$4,180	$3,903	$3,495	$3,293	$1,697	$1,405
Capital expenditures	(3,785)	(1,811)	(979)	(373)	(333)	(224)
Free cash flow	395	2,092	2,516	2,920	1,364	1,181
Sales	61,093	48,077	34,204	24,509	19,166	14,835
y-o-y sales growth	27%	41%	40%	28%	29%	39%
Net income	$(39)	$631	$1,152	$902	$645	$476
Cash	11,448	9,576	8,762	6,366	3,727	3,112
Debt	4,385	2,299	1,032	430	468	1,325
Net debt	(7,063)	(7,277)	(7,730)	(5,936)	(3,259)	(1,787)

source: The Bloomberg

by Bezos's lights, what's good for the customer is good for the stockholder. "That either-or mentality, that if you are doing something good for customers it must be bad for shareholders, is very amateurish," the author quotes his subject as saying.

What's been bad for the Amazon shareholder is bear markets—that and only that over the past decade-and-a-half. In just three weeks in June 2000, the price of AMZN broke to $33 from $57. Bezos kept up a brave front, scrawling, "I am not my stock price" on the whiteboard in his office. "You don't feel 30% smarter when the stock goes up by 30%," Stone quotes the visionary as telling the Amazon team during those dark days, "so when the stock goes down you shouldn't feel 30% dumber."

But when the stock goes up by 700% in just five years, as Amazon's has done, the average mortal might be inclined to feel smarter. Especially might those feelings wash over a body when, over the same five-year span, earnings per share declined at a compound annual rate of 29%. Watching the diverging trends of share-price appreciation and EPS depreciation, an observer might easily conclude that Amazon occupies its own special world with rules to match.

And one would be correct to this extent: Amazon funds itself by growing. It collects money from its customers in 20-odd days. It holds its inventories for not quite 50 days. It pays its vendors in 100-odd days. Nearby is a snapshot of Amazon's financial position. At year-end 2012, accounts receivable came to $3.4 billion, inventory to $6 billion and accounts payable to $13.3 billion. So despite minimal net income under generally accepted accounting principles, Amazon funds capital spending through operations. The year-end 2012 balance sheet showed $7.1 billion in net cash.

Put yourself in Bezos's shoes. In Amazon stock alone, you are worth $34 billion. They are writing books about you. Some people admire you, others fear you. You own the newspaper that Eugene Meyer and Katharine Graham built—and that digital technology, essentially your technology, unbuilt. You have changed the world. What next? What's next is a physical monument, Amazon's new, daring, greener-than-green, larger-than-life Seattle headquarters.

On Christmas eve, National Public Radio reminded its listeners that 2013 was the year of the techno-edifice. Apple, Facebook, Google—and Amazon—simultaneously broke ground for new corporate offices. Amazon is building in downtown Seattle. Three city blocks will accommodate three 38-story office buildings surrounding three glass domes—terrariums of a kind—in which fully grown trees will shade, refresh and

inspire the Amazon headquarters staff, including 12,000 anticipated new hires. Completion is slated for 2017.

What might the budgeted 3.3 million square feet of office space cost? No estimates have been published just yet, but paid-up subscriber Paul Isaac—an Amazon bear, let the record show—has an observation and a supposition. He points out that Amazon has earned cumulative net income of less than $2 billion ($1.964 billion through the third quarter of 2013, to be exact) since its founding in 1994. Not a lot of money for a business that has made such a noise in the world. And it would not be surprising, Isaac goes on, "given the complexity and novelty of the construction in a relatively high-cost area," if the final price tag on the new corporate village winds up absorbing both of those lonely two billions. "Twenty years in business, all this—as yet—unprofitable activity," Isaac marvels, "and they are going to blow the cumulative shareholders' net earnings on a snazzy new HQ?"

"The Everything Store" relates how Bezos once exploded in rage at a suggestion that the company's frequent flyers be allowed to fly business class. The man who proposed the big idea, Bill Price, vice president in charge of customer service, is quoted as to what happened: "You would have thought I was trying to stop the Earth from tilting on its axis. Jeff slammed his hand on the table and said, 'That is not how an owner thinks! That's the dumbest idea I've ever heard.'"

This was apparently in the year 2000, when Bezos was concentrating on not becoming his (plunging) stock price. Perhaps in the case of not becoming his (surging) stock price, the founder sold 2,193,115 Amazon shares for pre-tax proceeds of $711,159,646 in 2013. The book quotes a longtime Amazon executive, Rick Dalzell, saying that Bezos is inoculated against conventional thinking: "What is amazing to me is that he is bound only by the laws of physics."

Not flying too close to the sun is one such law. Especially is it relevant in a time of federally powered bull markets. Among all the companies in the S&P 500 for which Bloomberg has data, Amazon's trailing 12-month P/E ratio—the aforementioned 1,454 times—ranks highest. Something's got to give. We have a hunch it's going to be the Amazon multiple.

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Monetary action agenda

(November 14, 2014) On Nov. 6, the editor of *Grant's* delivered the keynote address at the 32nd annual Cato Monetary Conference in Washington, D.C. His remarks follow:

Thank you, Cato—and thank you Friedrich A. Hayek. Not quite 40 years ago, the newly minted Nobel Laureate issued his famous appeal for freedom of choice in currency. He didn't object to governments issuing money, said Hayek. He only objected to governments monopolizing the right to issue money. He expressed the hope that "it will not be too long before complete freedom to deal in any money one likes will be regarded as the essential mark of a free country."

You'd think that the world would have made up its mind by now. Money is as old as the hills. Credit, the promise to pay money, is as old as trust. Yet we earthlings still search for an answer.

Maybe we'll come up with something by five o'clock today. The need is urgent and obvious—to us. Yet we must pause to consider the fact that there is nothing either obvious or urgent about the idea of sound money to the people who own so much of the other kind. The asset-holding portion of the community has hugely profited by zero-percent funding costs and the levitation of stock, bond and real estate prices. The Dow is back to its highs. The U.S. Treasury is borrowing at yields that would lead a visitor from Mars to conjecture that the government is actually solvent. The dollar value of gold has been falling since 2011—meaning, reciprocally, that the world's faith in the pure paper dollar has been rising since 2011. If there's a crisis in money, it's news to most moneyed people. The bald fact is that we, believers in markets, are out of step with markets.

My self-appointed task this morning is to make the case that something is, in fact, very wrong. This being so, it behooves a critic to suggest the way forward. Or—bearing in mind Hayek's plea for choice—the many possible ways forward. Cato has lined up just the right people for the job.

Fundamental monetary reform is no easy sale in this time of not-so-terrible measured economic growth and sky-high asset prices. The QE-era dollar is still the Coca-Cola of world monetary brands. Not many, even in this room, would disdain to pick up a greenback if they saw one lying on the sidewalk. From the vantage point of monetary reform, the Republican triumph on Nov. 4 was not quite satisfying. Jeff Bell, running in New Jersey on a gold standard platform against Democrat Cory Booker, lost 56-42.

Still, it does amaze me that the system in place remains in place. You could write a book about its many demerits, and some of us have. One hundred years ago, we had the gold standard. Today, we have the Ph.D. standard. One hundred years ago, the stockholders of a nationally chartered bank were responsible for the solvency of the institution in which they owned a fractional interest. Today, we have too big to fail.

Progress is the rule in American enterprise. Retrogression is the rule in American money and banking. With respect to the dollar and high finance, we seem to be going backwards.

This is not the counsel of despair. As people consent to monetary arrangements, so may they withhold their consent. So may they press for alternative arrangements. It's easy to forget that in mid-20th-century America, no citizen could lawfully own gold. Principled men and women ended that New Deal fatwa as well as the kindred prohibition against entering into contracts specifying payment in gold. Writing in the snail-mail era, Hayek compared the government's monopoly over money with its monopoly over the post office. E-mail disrupted the post office. Maybe bitcoin or bitgold or something else will disrupt the Fed.

Something should disrupt it, before it ruins us. Every new financial crisis brings a bigger, more radical central-bank intervention. You wonder what they'll do the next time. At crisis-wracked intervals since 1993, they have pushed the federal funds rate steadily lower—to 3%, 2%, 1% and now zero percent. In Europe, the authorities have dropped short-dated yields to less than zero percent.

The great British journalist Walter Bagehot warned that ultra-low interest rates induce speculative bubbles. "John Bull can stand anything but he can't stand 2%," was Bagehot's epigrammatic phrasing of that idea. He meant a positive 2%.

The Yellens and the Draghis and the Kurodas are going to force a reconsideration of the theory of interest. Joseph Schumpeter called interest a "permanent net income. . . . [I]t flows," said he, "to the capitalist without ever exhausting the capital from which it comes and therefore without any necessary limit to its continuance." Well, yes and no. The Swiss government two-year note changed hands the other day at a price to yield minus 14.5 basis points to maturity. Minus 14.5 basis points, mind you. The minus sign means that your principal, instead of growing, shrinks. Continuously invested at that particular negative rate, one's principal would be sawed in half in 478 years. Call it usury in reverse. I hope the Pope is happy.

What's new today isn't ultra-low interest rates. They were as low in Queen Victoria's time as they are today. They were as low during Harry Truman's presidency as they are today. What's new is governmentally sponsored asset booms superimposed on ultra-low interest rates.

The complicity of the American financial establishment with this species of price control is another kind of monetary novelty. Interest rates are, of course, prices. They are the prices that set investment hurdle rates and that discount the present value of estimated future cash flows. They are the investment traffic signals of a market economy.

If you recall, the Fed was conscripted into government service in World War II. It became the bond-buying arm of the Treasury. Nor, come the peace, did the Treasury set its captive free. The Fed chafed under its continued subjugation. It bridled at pegging bond yields at 2¼% in the face of a virulent postwar inflation. Others protested, too, including the head of the New York Stock Exchange and the house economists at Bankers Trust and the National City Bank, today's Citibank. To strike a preemptive blow against flyaway asset prices, the Fed ordered that no one could buy stocks using margin debt. It was cash on the barrelhead or nothing.

You know the world has changed when the Fed not only doesn't resist an interest rate-induced bull market but actually sponsors one. In 2011, under gentle questioning from the CNBC correspondent Steve Liesman, then Chairman Ben Bernanke expressed his satisfaction at the lift-off of share prices. He singled out the Russell 2000 small-cap index for special mention. Its angle of ascent was even steeper and therefore more stimulative than that of the S&P 500. As justification for these intrusions, the Fed cited the theory of the so-called portfolio balance channel. My friend Paul Isaac, a talented Wall Street practitioner, assesses these radical policies in simpler language. They are, he observes, "the largest, most explicit and prolonged exercise in trickle-down economics in American history."

With respect to the radicalization of monetary policy, investors en masse resemble the sleepy frog in the warming saucepan. They don't jump out while the jumping's good. At that, professional investors couldn't jump if they wanted to. They're paid to invest, not to pass judgment on the administration of monetary policy. Monetary criticism is our line of work, not theirs. As a rule, theirs pays better.

The temperature in the Federal Reserve saucepan rose to the boiling point as long ago as Oct. 15, 1998. It was an options expiration day, therefore a day primed for stock-price volatility. Out of the blue at 3:04 p.m. EST came news of a one-fourth of 1% cut in the federal funds rate. In the next 56 minutes, the S&P 500 leapt by 7%. Long Term Capital Management was then combusting, but the world was hardly coming to an end; the unemployment rate stood at just 4 ½%. The feds knew which buttons to push, and they've kept right on pushing them.

It's a sign of the times that these interventions have come to seem normal. I'm reminded of Daniel Patrick Moynihan's phrase "defining deviancy downward." In monetary policy, the once unspeakable—indeed, unimaginable—has become the commonplace. You get a sense of how far we've come—either up or down, according to political and monetary preference—by recalling the close of the Bretton Woods system in 1971. The dollar had been defined as 1/35th of an ounce of gold. On Aug. 15, 1971, President Nixon redefined it as a piece of paper. Foreign governments had been entitled to exchange unwanted greenbacks for gold at that statutory rate. On Aug. 15, Nixon withdrew the privilege. Bretton Woods was far from the real gold standard. But it did exert a helpful check on American public finance. How starchy and orthodox it seems from the vantage point of QE.

It did not seem orthodox to Hayek. Good riddance to it, he said in 1976. "Wholly Keynesian" was his malediction on the post World War II monetary structure. You can only begin to imagine what Hayek would have to say about central banks conjuring dematerialized scrip on computer keyboards.

To what end do they conjure? Why, to beat back "deflation." By deflation, the mandarins mean a substandard rate of inflation. How the statisticians can calculate inflation rates to tolerances exacting enough to validate the debates over the difference between, for instance, 2% per annum and 1.7% or 1.8% per annum is beyond me. Neither do I understand why the central bankers refuse to admit that, in a time of technological wonder, prices ought to be falling. As it costs less to make things, so should it cost less to buy them.

Mario Draghi, president of the European Central Bank, is a champion of faux statistical precision. He has announced his determination to steer the fortunes of the continent of Europe according to the squiggles of something called the "five-year, five-year euro inflation swap rate." That would be a market-based expression of inflation expectations for the half-decade starting in 2019. Curious minds will wonder how any mortal being could accurately divine such a distant set of events.

Let us now imagine the scene in the boardroom of a German bank in the spring of 1914. A directors' meeting is in progress. The chairman of the board polls the assembled about the financial outlook. "Anyone care to venture a forecast of the rate of inflation eight years out?" he inquires. Here is what nobody says in reply: "A great war will shatter Germany and the world. Nothing will ever be the same again. The German cost-of-living index, now set at 1, will hit 218,000 million come November 1923. The mark will become worthless, after which it will become very worthless."

Returning to the 21st century, Switzerland is pledging to defend its cur-

rency with its last ounce of breath—that is, to protect it from unwanted appreciation against Draghi's euro. The Swiss National Bank is not purely a central bank. It is partly a wealth fund, partly a conjuring act. Its mission is to protect Swiss exporters against a too high Swiss franc exchange rate. To this end, the SNB creates Swiss francs by the gondola car-full. With those francs it buys euros. And with those euros (or some of them), it buys dollars. What to do with the dollars? Why, the Swiss buy American equities, $27 billion's worth at last report. Here's a metaphysical head scratcher. The francs cost nothing to create. Ditto, the euros and the dollars. Yet these disembodied monetary claims secure fractional interests in American public companies—something for nothing, indeed. On Nov. 30, Swiss voters go to the polls to cast their ballots on a referendum that would effectively take the Swiss National Bank out of the money-spinning business by requiring it to hold substantially more gold than it currently does. While the technical merits of the Swiss proposal are debatable, I applaud the spirit of this popular revolt against the rule of the monetary mandarins.

Trust is at the root of all monetary systems. Ours is peculiarly faith-based. We trust the central bankers—not you and me, perhaps, but most people. This trusting majority includes—critically—most people who hold the central bankers' money. In their turn, the central bankers trust the accuracy of the government's statistics on which they profess to be dependent. And the central bankers trust their so-called dynamic stochastic general equilibrium models. These are the econometric models that failed to flag the biggest, most disastrous credit event in the professional lives of the model builders. What the mandarins distrust is the resiliency of the price mechanism.

And yet, as I say, markets trust the mandarins. Sentient people are lending at some of the lowest rates in 50 years. They will be repaid in a currency of no intrinsic value that the Federal Reserve has pledged to depreciate at the rate of 2% a year. Still, they lend: 30-year Treasury bonds are priced to yield just 3.09%.

Under the classical gold standard, prices and wages were expected to adjust to economic disequilibria. Under the Ph.D. standard, it's interest rates and exchange rates and asset prices that are expected to do the adjusting.

You know about the gold standard. Money was a weight or measure, specifically a weight or a measure of gold. Bank notes were convertible into gold. The central banks of gold standard nations stood ready to exchange notes for gold and gold for notes at the fixed and statutory rate. Bullion moved freely from one gold standard nation to another.

In 1959, the Federal Reserve Bank of New York published a monograph on the workings of the classical gold standard. The author, Arthur Bloomfield, summarized thus:

> [F]rom about 1880 to 1914, the exchange rates of the various gold standard countries moved within narrow limits approximating their respective gold points without the support of exchange restrictions, import quotas, or related controls, which were virtually unknown even for currencies on paper or silver standards. . . . This remarkable performance, essentially the product of an unusually favorable combination of historical circumstances, appears all the more striking when contrasted with the turbulence of post-1914 international financial experience and remains, even today, a source of some measure of fascination and indeed of puzzlement to students of monetary affairs.

Well, if Eisenhower-era America scratched its head over the classical gold standard, what will futurity make of the Ph.D. standard? Likely, it will be even more baffled than we are. Imagine trying to explain the present-day arrangements to your 20-something grandchild a couple of decades hence—after the crash of, say, 2016, that wiped out the youngster's inheritance and provoked a central bank response so heavy-handed as to shatter the confidence even of Wall Street in the Federal Reserve's methods.

I expect you'll wind up saying something like this: "My generation gave former tenured economics professors discretionary authority to fabricate money and to fix interest rates. We put the cart of asset prices before the horse of enterprise. We entertained the fantasy that high asset prices made for prosperity, rather than the other way around. We actually worked to foster inflation, which we called 'price stability' (this was on the eve of the hyperinflation of 2017). We seem to have miscalculated."

Over the course of the day, you will hear monetary prescriptions from across the spectrum of Hayekian choice, from bitcoin revolutionaries to constitutional conservatives to gold standard adherents. Bearing in mind how little disposed is the monied world for thoroughgoing overhaul, perhaps we should not disdain the opportunity for achieving some small, interim victories.

To this end, perhaps the Cato staff could assemble a modest action agenda for the new Republican Senate. Why not—as a gesture of bipartisan comity—a bill to add, rather than subtract, a monetary bureaucracy? I would support legislation to create a new Department of Unintended Consequences within the Federal Reserve. Give it a big budget and a new, properly imposing headquarters building with lots of neon signage.

Or—another hand across the aisle to the liberals—a bill to institute free-range, fresh-from-market, organic interest rates in lieu of the government-issued hothouse kind?

Or—here I borrow from my friend Larry Parks—a bill to remove federal taxation from U.S. Gold and Silver Eagles? As Larry observes, "existing statutes and Supreme Court decisions already authorize these coins as legal tender currency for their face amounts. . . . If the IRS were to treat these coins as U.S. currency instead of 'property' in accordance with existing law and stop taxing them, economic laws will trump political laws."

I will account us victorious when the name of the chairman of the Federal Reserve Board is just as obscure as that of the chairman of the Weight and Measures Division of the Department of Commerce. Come to think of it, the monetary millennium will arrive when the dollar reverts to a tangible weight or measure—and perhaps, when the Weights and Measures Division and the Federal Reserve Board are joined in bureaucratic matrimony.

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Fuel least popular

(November 29, 2013) The Environmental Protection Agency makes war on it, people of any shade of green despise it, and the advent of cheap natural gas threatens to marginalize it. Coal—and a flourishing, $217 million market-cap coal miner—are the topics under discussion.

With the Nov. 14 news that the Tennessee Valley Authority will shutter eight coal-fired electricity-generating plants, the suspicion deepens that if anything could disprove the cheerful adage that all P.R. is good P.R., that something just might be coal. Even so, the official mineral of the state of Kentucky continues to generate 40% of America's electricity. Clean-burning natural gas accounts for just 27%.

Nor is coal likely to relinquish its lead in what is sometimes optimistically referred to as the "foreseeable" future. It will, by 2040, continue to claim as much as 35% of the electricity-generation market, compared to 30% for natural gas, projects the U.S. Energy Information Administration. That is, coal won't soon be going the way of the dinosaurs, from whence it came.

For connoisseurs of contrary opinion, Hallador Energy Co. (HNRG on the Nasdaq) ticks not one box, but two. Not only does it mine coal, but also its coal is the high-sulfur type that's linked to acid rain. To the question: "Why on earth would any utility choose to burn it—or be allowed to burn it?" There is this answer: Federal regulations long ago required utilities, at heavy expense, to neutralize those pollutants. "Counter-intuitively," Lucas Pipes, analyst with Brean Capital, advises colleague Evan Lorenz, "the increasing environmental standards have forced utilities over the tipping point to where it makes sense for them to burn higher-sulfur coal after they have installed higher-emission-standard technology."

So it is that high-sulfur coal is enjoying a renaissance. It's found in abundance in the so-called Illinois Basin, which encompasses the Land of Lincoln and parts of Indiana and Kentucky. Reserves in this locale are relatively accessible and extraction costs are relatively low—on the order of $30 a ton, about half the cost of the low-sulfur coal buried in the immense Central Appalachian Basin, a region stretching as far north as the Canadian border and as far south as Alabama.

Coal is in a steep bear market; the price of central Appalachian coal traded on the Nymex has declined to $54.93 per ton, down from $143.25 on July 1, 2008. But even at $44.50 a ton, the average price for all regions in 2013, mines like Hallador's operate in the black. Not so their Central Appalachian counterparts. Since 2005, according to Pipes, annual production in the Illinois Basin has expanded to 135 million from 93 million tons, while that in the central Appalachian zone has contracted to 75 million tons from 216 million tons.

"Within the coal industry," Lorenz points out, "there are lots of losers—and one or two winners. Conspicuous among the former are the companies that leveraged to expand at the top of the 2007-08 energy cycle. Arch Coal, Peabody Energy Corp. and Consol Energy are among these encumbered unfortunates. James River Coal Co., which had a market cap of $704 million at year-end 2010, is quoted today at $54 million. Patriot Coal Corp., which had a market cap of $1.8 billion at year-end 2010, filed for bankruptcy protection in July 2012."

A very different proposition is Hallador, a lightly leveraged, low-cost, pure play on the Illinois Basin. Wholly owned Sunrise Coal is Hallador's principal business unit; it's responsible for all but $4.2 million of the company's $25.2 million in trailing 12-month operating income. Savoy Energy LP, a private oil and gas exploration company in Michigan, and Sunrise Energy LLC, a private oil and gas exploration company in Indiana—Hallador owns 45% of the first and 50% of the second—round out the corporate stable. As of Sept. 30, the parent's balance sheet showed $11.4 million of debt against $13.7 million of cash.

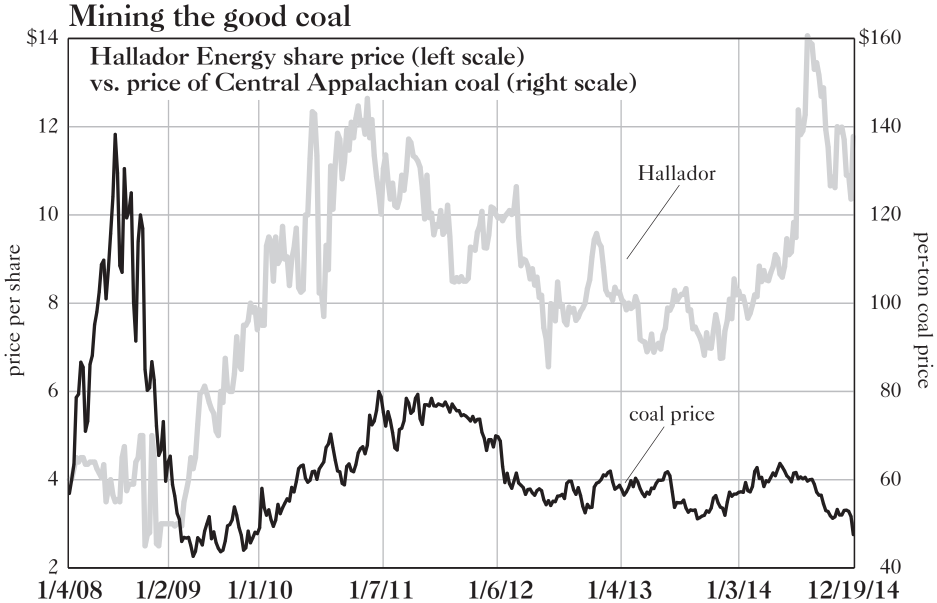
Hallador, via Sunrise, extracts coal at a cost of less than $30 a ton, the lowest cost of any public miner (only closely held Foresight Energy LLC, controlled by the farsighted Chris Cline, posts a lower cost per ton). The great bulk of the company's coal comes from the Carlisle mine, situated near the Indiana town of the same name. The Carlisle is a high-sulfur, underground deposit from which "continuous" mining machinery can surface as many as six tons of coal per minute. Carlisle has a capacity of 3.3 million tons a year and identified reserves of 43.5 million tons.

While Hallador's Ace-in-the-Hole mine, 42 miles northeast of Carlisle, a low-sulfur surface project, chips in a half-million tons in annual productive capacity and 3.1 million tons of reserves, and while management is developing a pair of much larger deposits on the Indiana-Illinois border (the so-called Bulldog and Russellville Mines), the fact is that, for now, Hallador is a one-mine company, with all the risks that concentration entails. For instance, in the first three quarters of this year, the cost of production at Carlisle jumped to $28.37 a ton from $26.53 in the 12 months of 2012. It was the discovery of a pocket of high gas (the same heat and pressure that transforms organic material into coal also produces highly flammable methane) that caused the bump up in cost; mining operations had to be moved to less productive parts of the mine while ventilation shafts were sunk to address the gas problem. The result: Cash flow in the 12 months to Sept. 30 declined to $27.8 million from $37 million in calendar 2012.

Another thing for the would-be investor to consider is the inescapably capital-intensive nature of the mining business. Capital expenditures, which totaled $40.5 million over the last 12 months, up from $26.2 million in 2012, have been inflated by $9 million for the purchase of Ace-in-the-Hole, $4 million for land around Carlisle and Bulldog and costs to permit the two new mines. To bring either into production at Carlisle's three-million-ton-per-annum rate would require an additional $150 million. Management estimates that maintenance capital expenditures will run between $3.50 and $4 per ton of capacity, or approximately $12-$13 million for the Carlisle mine.

"We don't operate on a factory floor where it is the same every day," Brent K. Bilsland, president of Sunrise Coal, reminds Lorenz. "Mining is about

Mining the good coal



source: The Bloomberg

Hallador Energy Co.
(in millions of dollars, except per-share data)

	12 mo. 9/30/2013	2012	2011	2010	2009	2008	2007
Coal sales	$136.2	$138.0	$129.0	$117.4	$70.3	$27.2	$0.0
Other revenue	3.4	2.3	(0.8)	0.5	0.4	0.5	0.0
Coal operating expenses	118.6	105.8	99.3	90.7	78.3	51.2	28.4
Coal operating income	21.0	34.6	28.9	27.3	(7.6)	(23.4)	(28.4)
Equity income (Savory)	3.5	2.0	5.5	1.0	(1.7)	(2.3)	0.0
Equity income (Sunrise Energy)	0.6	0.2	0.9	0.0	0.0	0.0	0.0
Total operating income	25.2	36.8	35.3	28.3	(9.3)	(25.7)	(28.4)
Interest expense	1.5	1.1	1.3	1.9	2.0	4.0	4.1
Profit before tax	31.1	34.5	56.7	36.6	36.0	13.6	(2.8)
Net income	23.5	23.8	35.8	22.4	20.2	8.9	(2.4)
Diluted shares (in millions)	28.8	28.8	28.7	28.6	24.4	19.3	13.3
EPS	$0.82	$0.83	$1.25	$0.78	$0.83	$0.46	($0.18)
Cash	$13.7	$21.9	$37.5	$10.3	$15.2	$21.0	$7.0
Debt	11.4	11.4	17.5	27.5	37.5	40.0	35.4
Net debt	(2.3)	(10.5)	(20.0)	17.2	22.3	19.0	28.4
Oper. income/int. expense	17.1	33.5	27.4	14.7	(4.5)	(6.4)	(6.9)
Cash flow	27.8	37.0	60.1	45.5	45.2	18.8	(1.5)
Capital expenditures	(40.5)	(26.2)	(33.0)	(35.6)	(43.5)	(21.9)	(17.2)
Free cash flow	(12.7)	10.8	27.1	9.9	1.7	(3.1)	(18.8)

source: company reports

following the geology. From time to time, we have all four of our mining units in great conditions, and from time to time, we have three out of four in bad conditions."

There's no confusing Hallador with Exxon in the stock-market liquidity department; management, the board and affiliates own two-thirds of the 28.6 million HNRG shares outstanding. One-half of this chunk of inside holdings is persistently shrinking. Yorktown Energy Partners LLC, owner of 9.7 million shares, or 34% of the outstanding, has been distributing blocks of 750,000 shares to its limited partners every quarter or so. Many of the recipients turn right around and sell their Hallador in the open market.

Yorktown tells Lorenz that its exit from Hallador is no reflection on the company or its management. The fact is, rather, that the investment funds holding Hallador shares are nearing the end of their respective lives. "We wouldn't distribute a stock we thought either had issues or we thought was highly overvalued," Yorktown partner, Peter Leidel, says. "We want to distribute stocks we think people can hold and do well with. We think the stock ought to be higher than it is, but coal is out of favor."

Perhaps this overhead supply weighs on the share price. Certainly, the coal bear market does the stock price no good. In any case, the shares trade at 10.2 times trailing net income and yield 2.1%; they're quoted at a multiple of enterprise value to EBITDA of five times.

Whether you consider Hallador cheap at the price will depend, in part, on your view of natural gas. On this score, it's notable that gas prices weighed in at an average of $2.73 per million Btus in 2012 but have averaged $3.58 per million Btus so far in 2013 and are tipped to rally to $3.81 in 2014 (so, at least, tips the gas futures market). It's not inconceivable that coal, in relation to gas, is as cheap as it's going to get for a while. "When the ratio of natural gas prices to coal prices is approximately 1.5 or lower [per million Btu], a typical gas-fired combined-cycle plant has lower generating costs than a typical coal-fired plant," the EIA noted in its Annual Energy Outlook 2013. Coal, according to the agency, is expected to command $2.20 and $2.29 per million Btu in 2013 and 2014, making the black mineral cheaper to burn than natural gas.

"Hallador gets credit for what it is," Lorenz observes—"that is, a low-cost producer in a geologically fertile region. But it gets little, if any, credit for its two oil and gas development businesses, or for what its coal-mining operations might become. What management hopes to become is much bigger—and could be. To bring either Bulldog or Russellville into production would take nine months and the previously cited $150 million. 'Either one of those projects doubles our company,' Bilsland tells me. 'We are trying to get into a position where five years from now, we can bring three or four more new projects and triple the size of our company. That's our goal.' The financing would appear to be available: Hallador has in place a revolving credit facility of $165 million, of which $153.6 million remains untapped. Hallador's covenants limit the company's borrowings to 2.75 times EBITDA. Management takes a dim view on diluting ownership via an equity raise and would prefer to fund growth via cash flow and its credit facility, even if that means it takes longer to ramp up a new mine."

"What I like about this management team is that they are rational deployers of capital," Mat Klody, managing partner of the Chicago-based hedge fund, MCN Capital Management, and a Hallador shareholder, tells Lorenz. "They didn't do a lot of stupid things at the peak of the cycle and now they are seeing a lot of potential M&A opportunities pop up. They've been cautious to date about deploying capital, in particular with the great organic opportunities in place. They are definitely opportunistic."

"Opportunistic"—in capitalist circles, it's the highest praise.

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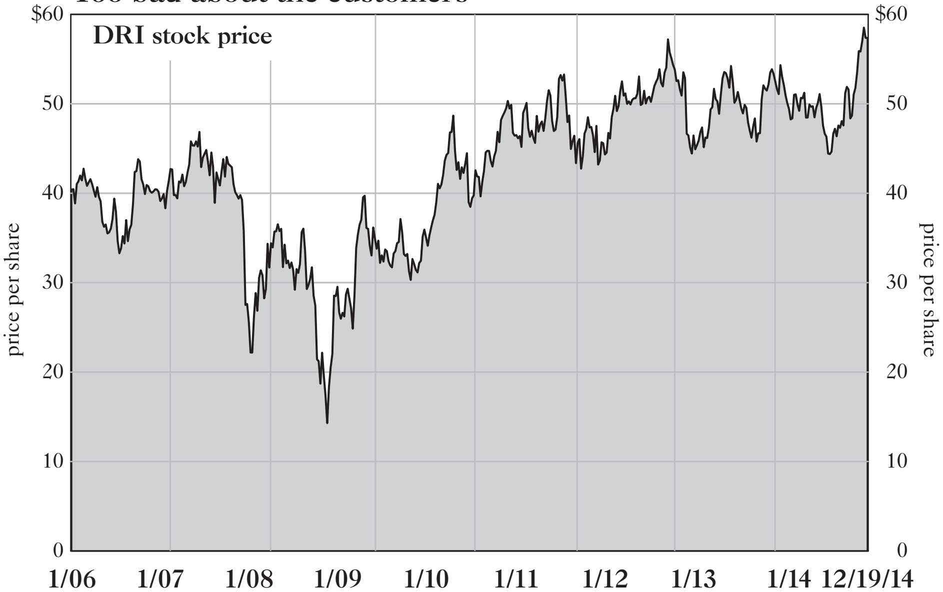
A personal message for Larry Summers

(November 29, 2013) I thought I heard a wistful tone in your voice as you delivered your widely YouTubed remarks at the IMF Annual Research Conference on Nov. 8. In particular, I detected a note of regret when you

Too bad about the customers



source: The Bloomberg

began a sentence with the phrase, "Were I a member of the official sector. . . ." Believe me, I know what it's like to be excluded from the official sector. Out of the blue in 2011, Ron Paul announced that I would be his Fed chairman if he won the presidency. Well, he didn't win, and I'm still editing *Grant's*. So here we are together, disappointed non-central bankers. I expect you feel the same kinship toward me as I do toward you.

Anyway, I'm presuming on our shared experience to write you about your IMF speech. Blood brother to blood brother, it was enough to curl the hair of a normal non-economist. How to restore America's once and future economic vitality? Why, you said—or allowed the audience to infer you meant—that the government must borrow more, spend more, print more, because even zero is too high an interest rate for the world in which we live, a world of "secular stagnation," you called it. And to think, as between you and Janet Yellen, you were supposed to be the reasonable one.

I did love the part of your speech where you compared a financial crisis to a power failure. The lights go off, the grid goes dark and the economy stops cold. In response to which, as you conjectured, "There would be a set of economists who would sit around explaining that electricity was only 4% of the economy and so if you lost 80% of electricity you couldn't possibly have lost more than 3% of the economy! And there would be people in Minnesota and Chicago writing that paper!" It was good to hear the knowing laughter you raised in that audience of economists. Wisdom begins with self-awareness.

Allow me to observe, my fellow non-Fed chairman, that you seem not to admit the possibility that what ails American enterprise is the institution that neither one of us is running. I am going to say that ZIRP, QE and Twist have so distorted current and prospective rates of return that entrepreneurs are stymied rather than stimulated. Biotech stocks are going up a percent a day. Credit spreads have collapsed. Pieces of middlebrow contemporary art fetch $100 million at Christie's.

You seem to welcome these orbiting asset values. As you put it to the audience, "It has been demonstrated, less conclusively but presumptively, that when short-term interest rates are zero, monetary policy can affect a constellation of other asset prices in ways that support demand. . . ." But, if you don't mind my asking, what kind of demand and for how long?

I don't have to tell you that real American median income was lower last year than it was in 1989, that student debt tops $1 trillion (more than auto loans, credit-card loans and home-equity balances combined) and that companies that cater to the middle class are treading water, if not slipping under it. Target Corp., Wal-Mart and Gap are reporting essentially flat same-store sales.

Casual dining is an especially instructive disaster area: From 2006 through 2012, same-store sales at Red Lobster, LongHorn Steakhouse and the Olive Garden fell a cumulative 13.8%, 8.9% and 6.2%, respectively, according to a J.P. Morgan research note dated Oct. 8. Because, over the same span, inflation increased by 16.7%, real same-store sales at the aforementioned chains dropped by a quarter. Darden Restaurants (DRI on the New York Stock Exchange), which owns those outlets and derives 88% of its revenue from them, earned 11.4% on assets in fiscal 2006 but only 6.4% on assets in fiscal 2013, ended May.

And here's the kicker: The stock market loves Darden. It loves it for its financial engineering. It wasn't the food that generated growth in earnings per share of 5.4% a year between 2006 and 2013. The secret to this feat was growth in debt; net borrowings were up by 22.2% a year over the same span. Now the shares change hands at 18.7 times earnings and 9.6 times enterprise value (market cap plus net debt) to EBITDA (earnings before interest, taxes, depreciation and amortization). It's almost as rich a valuation as the ones that made the peak of the 2007 private-equity boom.

My friend John Hamburger, president of *Restaurant Finance Monitor*, sponsored his annual restaurant finance conference in Las Vegas this month. And do you know what he reported to his subscribers about that event? He told them that among the attendees were the "largest number of restaurant lenders, investors and restaurant operators on hand in our 24-year history." And he added, "While we're more than happy to take credit for superior organizing skills, a big shout-out goes to the Bernanke-Yellen credit palooza. . . ." It can't be a good sign that working Americans can hardly afford to eat at the restaurants on which the bankers and promoters continue to extract fees and to heap leverage.

I think I can guess what you're going to say, because you said it at the IMF meeting. You're going to say that Ben Bernanke's Stakhanovite feats of money conjuring very likely saved the world from having to reprise the years 1929-33. You can't prove it, and I can't disprove it. But why this harking to the Great Depression and only the Great Depression? You'd think it was the only cyclical event in American history.

I myself have been thinking about the depression of 1920-21. Measured from peak to trough, this bump in the road featured drops of 31.6% in industrial production, 46.6% in stock prices and 40.8% in wholesale prices. The collapse in wholesale prices was reckoned the most violent in American annals up until that time. No reliable data exist on unemployment, but contemporary guesswork put the figure in the teens. And do you know how the administrations of Woodrow Wilson and Warren G. Harding met this calamity? They balanced the budget and, through the Federal Reserve, raised—not lowered—interest rates. They made no attempt to prop up wages or prices but let them find their own level (the Fed was, in fact, promoting deflation). After which, a vibrant and job-filled recovery began and the 1920s proverbially roared. Say, I happen to have written a short book on the 1920-21 depression that Simon & Schuster is going to publish next year. The working title is, "Triumph of the Invisible Hand." May I count on you for a blurb?

We can all agree that the American economy is in a kind of trance. You pin the blame—the immediate blame—on the government, saying, or again implying, that it hasn't done nearly enough. "Imagine," you said at the IMF, "a situation where natural and equilibrium interest rates have fallen significantly below zero." In such a situation, you broadly hint, QE forever would be just what the doctor ordered.

Maybe you've seen John B. Taylor's critique of your speech. In rebuttal, that eminent Stanford economist says there's no need to imagine the cause of our long-lingering non-recovery. The Affordable Care Act, Dodd-Frank and the 2013 payroll-tax hike are staring us right in the face. I happen to agree with Taylor. But I'm beginning to wonder if the supposed science of macroeconomics isn't just politics dressed up in algebra.

One more thing: On camera with Bloomberg TV on Nov. 21, you seemed awfully sure of yourself that history would vindicate today's radical monetary measures. "On the question of whether the Fed stepping up and providing liquidity when no one else would was the right thing to do, I think historians are going to judge that about 98 to 2," were your exact words.

Concerning what future historians might or might not say, you should really treat yourself to the YouTube clip of former President George W. Bush bantering with Jay Leno. Bush is saying that he's been reading some recently published books about George Washington. "If they're still writing biographies of the first guy," drawls W. in his funny-humble way, "the 43rd guy doesn't have to worry about it."

Isn't that charming?

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