GRANT'S

August 19, 2015

JAMES GRANT
EDITOR

Vacation delectation

To the readers, and potential readers, of *Grant's*:

This anthology of recent articles, our summertime e-issue, is for you. Please pass it along, with our compliments, to any and all prospective members of the greater *Grant's* family.

Not yet a subscriber? Make yourself the gift of a year's worth of *Grant's* and get two issues added on to your subscription. That's a $230 value.

We resume regular publication with the issue dated Sept. 4 (don't miss it!).

Sincerely yours,

James Grant

Subscribe today and save! Fax or mail the form below, go to www.grantspub.com/sb2015 or call 212-809-7994.

❑ **Yes, I want to subscribe.**
Enclosed is my payment (either check or credit card).
(I understand I may cancel at any time for a prorated refund on the remainder of my subscription.)
Order by the deadline and we will add two free issues **—an additional $230 value—**onto the end of your subscription.

❑ 1 year (~~24 issues~~) **26 ISSUES for $1,175 U.S./$1,215 Foreign**
❑ 2 years (~~48 issues~~) **50 ISSUES for $2,125 U.S./$2,165 Foreign**
❑ Check enclosed*
*Payment to be made in U.S. funds drawn upon a U.S. bank made out to Grant's.

#____________________ Exp. ________
Credit card number

Signature ____________________

CV number __________(3-digit code on back of VISA/MC/Disover; 4-digit code on front of AMEX)

Offer good until December 15, 2015
Order online: Offer code:SB2015

Questions? Call 212-809-7994.
Fax your order: 212-809-8492

Name ____________________
Company ____________________
Address ____________________

Daytime Phone (required) ____________________
E-mail ____________________

TWO WALL STREET • NEW YORK, NEW YORK 10005-2201 • WWW.GRANTSPUB.COM

GRANT'S
INTEREST RATE OBSERVER®
Vol. 33 Summer Break Two Wall Street, New York, New York 10005 • www.grantspub.com AUGUST 19, 2014

Not such a lock

(February 6, 2015) A wave of identity theft and computer-borne financial fraud has hoisted LifeLock—LOCK on the New York Stock Exchange—into the elite ranks of American growth stocks. "Elite" is no part of the LifeLock corporate story, *Grant's* is about to contend. On the company whose CEO famously paraded his own Social Security number in front of the TV cameras just to dare bad actors to steal it (which the taunted thieves actually proceeded to do), this publication is bearish.

Anxiety is LifeLock's stock in trade. If North Korea (let us say) can hack Sony Pictures Entertainment, and if JP Morgan Chase, Home Depot and Target are likewise vulnerable to digital intruders, which ordinary citizen is safe? Some 3.5 million Americans, deciding that they, at least, are unsafe, have signed on. In the 12 months through Sept. 30, LifeLock's revenues jumped by 30% from the year-earlier period. From 2007 through 2013, compound annual growth in the LifeLock top line amounted to no less than 64%; results for the final quarter and full-year 2014 are due on Feb. 10.

Between five and 15 million Americans are annually hacked, according to estimates by Forrester Research and the Department of Justice. "Let's assume," Richard Davis Jr., analyst with Canaccord Genuity, muses with colleague Evan Lorenz, "the only people who have any interest in this product is someone who actually had their identity hacked. So, that's seven million people per year. With LifeLock's churn, which is about 18%, they have to land about 1.2 million of that seven million, so they have to get 17% of those people in that narrowly defined universe of people who had their identities hacked. If that's all they won, a 17% win rate is not that bad. It's not like they need 50% to 60%."

The argument appears to have carried the day with all but one of the nine analysts who follow the company. The shares are valued at 28.9 times trailing net income and 22.7 times the 2015 estimate. Cash per share works out to $2.55; the balance sheet is debt-free. Not since going public in October 2012 has management produced a disappointing quarter. Boldface names—Goldman Sachs, Bessemer Venture Partners, Kleiner Perkins Caufield & Byers—furnished venture capital. Tom Ridge, former head of the Department of Homeland Security, sits on the board of directors.

What, exactly, does LifeLock deliver? Less than the "comprehensive identity theft protection" that it claims. The standard LifeLock protection plan, which sells for $9.99 a month, buys you notification if a credit card account (or mortgage or mobile phone application) is opened in your name. It promises assistance in canceling lost or stolen credit cards. It guards against attempts to tamper with your address. It scans Web sites for signs that someone is filching your vital data, and it blocks pre-approved credit card offers and offers a $1 million service guarantee in case of fraud. For the customer who wants to know if a registered sex offender has moved into his neighborhood or who demands instant notification of major corporate data breaches, higher and costlier levels of service are available. Except for a small enterprise division that verifies customer bona fides for corporate clients, consumer protection is LifeLock's beating heart.

"Fiat, boys! I found fiat!"

You might suppose that the anti-identity theft industry is thriving. In fact, annual average top-line growth over the past five years amounted to just 0.5%, according to Sarah Kahn, analyst at IBISWorld. Revenue at the only other public company focused on identity-theft protection—Intersections Inc. (INTX on the Nasdaq)—slipped to $262 million in the 12 months ended Sept. 30, 2014, from $373 million in calendar 2011. Intersections markets through banks, where it has collided with the Consumer Financial Protection Bureau. LifeLock has had no such difficulty issuing ads to the hack-wary public.

Many a business in the Internet age has foundered in failing to compete with services that someone, somewhere can deliver for free. Perhaps such a fateful encounter awaits LifeLock. "Consumers can request their credit reports once a year from each of

the three credit bureaus for free," as Lorenz points out. "Anyone can reduce the number of pre-approved credit offers at the Consumer Credit Reporting Industry Web site at optoutprescreen.com. Many banks now offer fee alerts for transactions over a size specified by consumers. Anyone can check online registries to see if sex offenders live nearby, again at no cost. MasterCard now offers identity theft alerts, i.e., the core component of LifeLock's product, for free —just go to http://www.mastercard.us/idtheftalerts/ to enroll."

And as for "credit monitoring," said *Consumer Reports* last year in the wake of the Target data breach, it "is not much use for most of what is now called 'identity theft,' which involves old-fashioned credit card theft, because monitoring watches your credit report, not unauthorized charges to your existing accounts."

Did that $1 million LifeLock insurance policy catch your eye? After deducting lawyers' and investigators' fees, and the cost of other 'third-party' services that the company judges to be essential to clean up after the fraud, the hopeful insurance-policy holder is likely to realize not much more than $50,000. You can satisfy yourself on this point by consulting the fine print of the service agreement on the company's Web site.

One might suppose that management could find in its commodious third-party services' budget the funds with which to hire a fact checker. Apparently not, as more than a few corporate representations, starting with the tale of how LifeLock came into being (ostensibly as a result of an identity theft perpetrated against co-founder Robert J. Maynard Jr.) don't stand up to scrutiny. For chapter and verse on the checkered LifeLock back story, see the lengthy and thoroughly reported article by Ray Stern in the *Phoenix New Times* almost eight years ago. Accuracy in corporate reporting is still an elusive ideal at LifeLock to judge by the 2014 proxy, which flatters the resumé of CEO Todd Davis by identifying him as a "Certified Identity Theft Risk Management Specialist" (no such record exists), a member of the Crime Prevention Coalition of America (not according to our check), and a "contributing member of the Identity Theft Prevention and Identity Management Standards Panel that worked with the Identity Theft Task Force established by former President Bush" (again, evidence is wanting). Asked for comment, the company declined.

Anomalously for a business with a Goldman Sachs-Bessemer-Kleiner Perkins-Tom Ridge pedigree, LifeLock has had a recurrent series of scrapes with lawyers and regulators. The evident gap between performance and promise is the usual source of conflict. Thus, in a March 2010 settlement with the Federal Trade Commission and 35 state attorneys general, the company agreed to stop making false claims, including the representation that its products provide "complete protection against all forms of identity theft by making customers' personal information useless to identity thieves."

Almost five years later, LifeLock continues to make exactly that kind of claim—"comprehensive identity theft protection" is the slogan on the home page. Whether—as the company insists—the FTC injunction no longer applies because management has tweaked the LifeLock business model is an issue that we look forward to seeing resolved in some future regulatory hearing. The FTC is known to be taking another look at the situation; asked for comment, the commission declined.

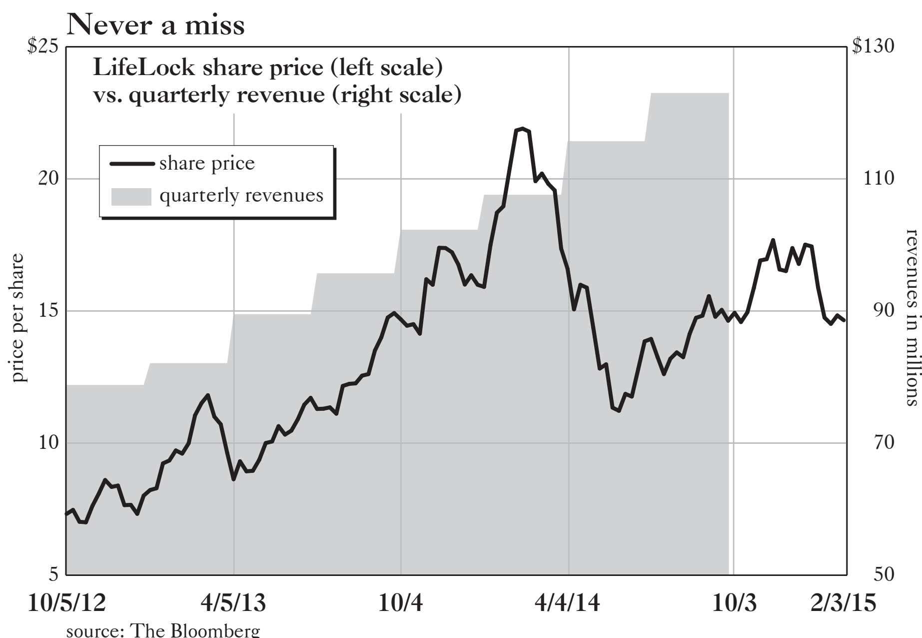
If the federal sleuths find themselves running short of material, may *Grant's* suggest that they examine the March/April 2014 edition of AAA's *Via* magazine? In it, LifeLock seems to advertise protection against "tax return fraud." We say "seems" because the IRS disseminates no data pertaining to any individual's tax returns. What LifeLock could contribute to the security and peace of mind of the tax-paying public is, to us, a mystery.

Like the cobbler's unshod children, according to the FTC complaint, LifeLock's computer systems were themselves vulnerable to hacking. To address the deficiency, the company hired Michael D. Peters as chief information security officer on July 1, 2013. Before the month was out, the company fired him. In a whistle-blower suit filed in March 2014, the ex-employee alleged that LifeLock's substandard security protocols put the well-being of the firm's own phobic customers at risk. (Peters charged that the putative cause of his dismissal, sexual harassment, was the company's malicious invention.)

"This is a company," David Swartz, analyst at Pacific West Land Co. and an owner of puts on LOCK, tells Lorenz "that stores people's Social Security numbers, bank account numbers, credit card numbers—everything. If someone hacks LifeLock, they get everything. The FTC could say they are putting millions of people at risk just by operating, which I believe they are."

A separate legal action brought by another disgruntled former LifeLock employee, Stephen P. Burke, in July 2013, repeated some of Peters' claims. The suit alleges that the volume of account alerts has overwhelmed LifeLock call centers. To quote from Burke's complaint: "The problem of timely informing customers that their

Never a miss



source: The Bloomberg

LifeLock
(in $ millions unless otherwise indicated)

	12 mo. thru Sept. 30, 2014	2013	2012	2011	2010	2009
Revenue	$448.6	$369.7	$276.4	$193.9	$162.3	$131.4
Cost of services	115.9	100.1	79.9	62.6	51.4	43.1
Gross profit	332.8	269.6	196.5	131.3	110.8	88.3
Operating expenses	317.7	252.4	183.4	126.5	123.5	143.6
Income from operations	15.1	17.2	13.1	4.8	(12.7)	(55.4)
Net interest expense	(0.2)	(0.2)	(3.6)	(0.2)	(1.3)	(1.3)
Other	(0.2)	(0.0)	0.3	(8.7)	(1.4)	(2.0)
Profit before tax	14.7	16.9	9.8	(4.0)	(15.4)	(58.6)
Taxes (benefit)	(37.9)	(37.5)	(13.7)	0.2	0.0	0.0
Income after tax	52.6	54.5	23.5	(4.3)	(15.4)	(58.6)
One time items	0.0	0.0	(17.3)	(18.9)	(16.1)	(10.3)
Net income	52.6	54.5	6.2	(23.2)	(31.5)	(68.9)
Shares in millions	92.4	96.0	62.2	18.7	18.1	17.8
EPS	$0.55	$0.57	$0.09	($1.24)	($1.74)	($3.86)
Cash	238.3	172.6	134.2	28.9	17.6	
Pref. equity	0.0	0.0	0.0	145.2	126.3	
Debt	0.0	0.0	0.0		13.2	
Net debt (cash)	(238.3)	(172.6)	(134.2)	116.3	121.9	

sources: company filings, the Bloomberg

credit information was accessed is so widespread that Defendant instituted a code freeze. In essence, Defendant is deliberately 'stepping on the brakes' with regard to sending this critical information to customers on a timely basis, and worse, often choosing to not send these alerts out at all. This practice has been referred to a 'throttling'."

A class action suit brought on Jan. 19 in the Northern District of California charges the company with—among other shortcomings—a failure to "maintain security standards as promised."

Once upon a time, McDonald's kept a running tally of the hamburgers it sold. In a similar vein, LifeLock monitors the cumulative number of alerts it has broadcast. As of March 31, 2014, the tally was 3,615,357. "It seems low enough to lend some circumstantial support to Burke's allegations," Lorenz observes. "Thus, between 2007 and the first quarter 2014, LifeLock had a grand total of 5.3 million customers, implying that each customer, on average, received just 0.68 alerts over a period of seven years. Now, the typical family moves about once every six years, and a change of address in major financial records is something LifeLock claims to monitor. You'd expect that between 2007 through March 31, 2014, at least 2.5 million alerts might have been issued just in connection with moving."

The FTC, as noted, appears to be re-examining its case. On Jan. 17, 2014, the agency met with the company to discuss the Peters' allegations. In the week before the meeting, insiders sold 79,303 shares for $1.4 million. On March 13, the FTC requested more documents and information relating to the company's compliance with the 2010 settlement. On Oct. 29, LifeLock finished sending those papers. If the commission finds that the company has failed to comply with the 2010 settlement, the range of penalties runs from a slap on the wrist to an order to shut down operations and turn out the lights.

With a $1.4 billion market cap and short interest at 12.3% of the float, LOCK is hardly a crowded short. The insiders are heavy sellers of the stock. Nobody has called them stupid.

•

The balance sheet that ate Switzerland

(Septemqxber 19, 2014) Like a celebrity in flight from the paparazzi, the Swiss Confederation demands protection from its pesky admirers. To beat back the unwanted appreciation of the Swissie, the Swiss National Bank is—once again—vowing to move heaven and earth.

Now under way is a speculation. Prompted by a friend (that's you, Harlan Batrus), we venture that the SNB will sooner or later be forced to permit the franc to appreciate and thus to enrich the holders of low-priced, three-year call options on the Swiss/euro exchange rate. It's a long shot, to be sure—the options are cheap for a reason—but we judge that the prospective reward is worth the obvious risk.

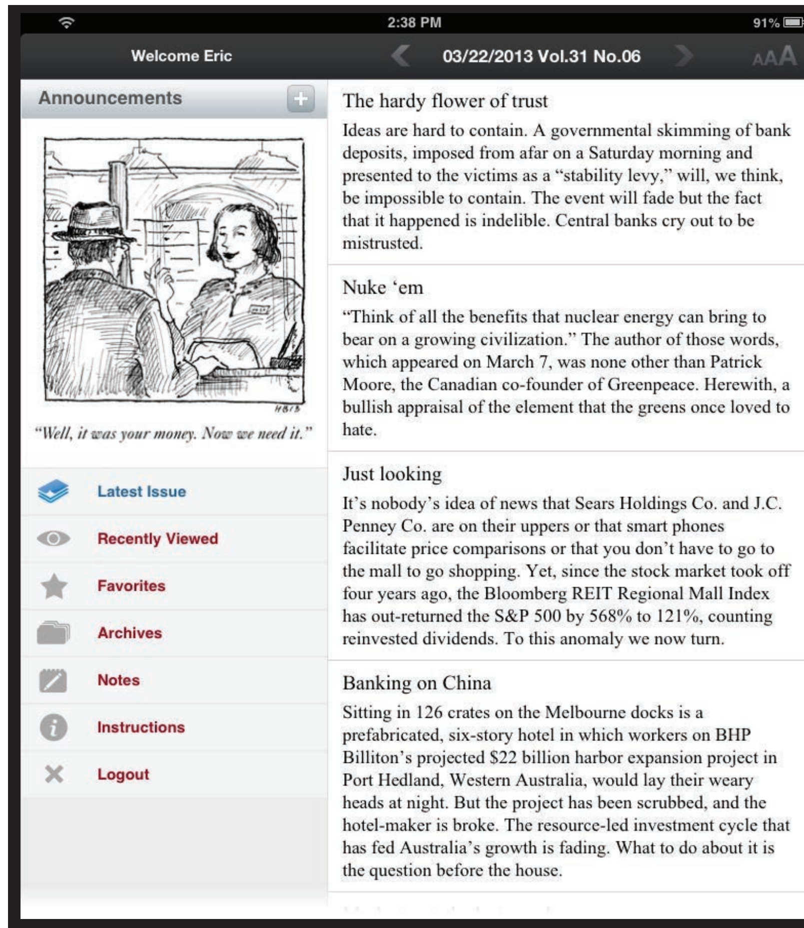
Curiously, for all the damage that Swiss private banks have suffered at the hands of American regulators, and for all the Federal Reserve's throat clearing about the supposed imminent rise in dollar interest rates, the franc is still, for many, the monetary bolt-hole of choice. To the Swiss, whose exports generate 54% of Switzerland's GDP, it's a kind of popularity they can live without—indeed, they insist, must live without.

So the SNB prints francs. It drew a monetary line in the sand three years ago: The franc shall not rally through the 1.20-to-the-euro mark, the authorities commanded in September 2011. To enforce this dictum, they bought euros with newly created francs (the cost of production of the home currency being essentially zero). What to do with the rising euro mountain? Invest it, of course.

CFA fashion, the central bankers are diversifying across asset classes and currencies. Among these asset classes are equities, and among these currencies is the dollar. As of June 30, the Swiss managers held $27 billion in 2,533 different U.S. stocks, according to the bank's latest 13-F report (the gnomes file with the SEC just like ordinary big hitters, say George Soros or Goldman Sachs Asset Management).

Here's a metaphysical head scratcher. The Europeans conjure euros, which the Swiss buy with their newly materialized francs. The managers exchange the euros for dollars (also pro-

GRANT'S is now available on ANY mobile device.



Download for your iPad®, iPhone®, Android™ or Windows 8 Device.

Did you know that ***Grant's Interest Rate Observer* is available on multiple platforms and devices?** The *Grant's* app works with iPad, iPhone and iPod touch.® *Grant's* also works on all Android devices, and we just added an app for Windows 8.

Simply download the free *Grant's* app from the App Store℠ for your Apple devices, from Google Play™ for Android devices, or from Windows Store for Windows 8 devices.

Questions or comments? Call 212-809-7994.

Available on the App Store

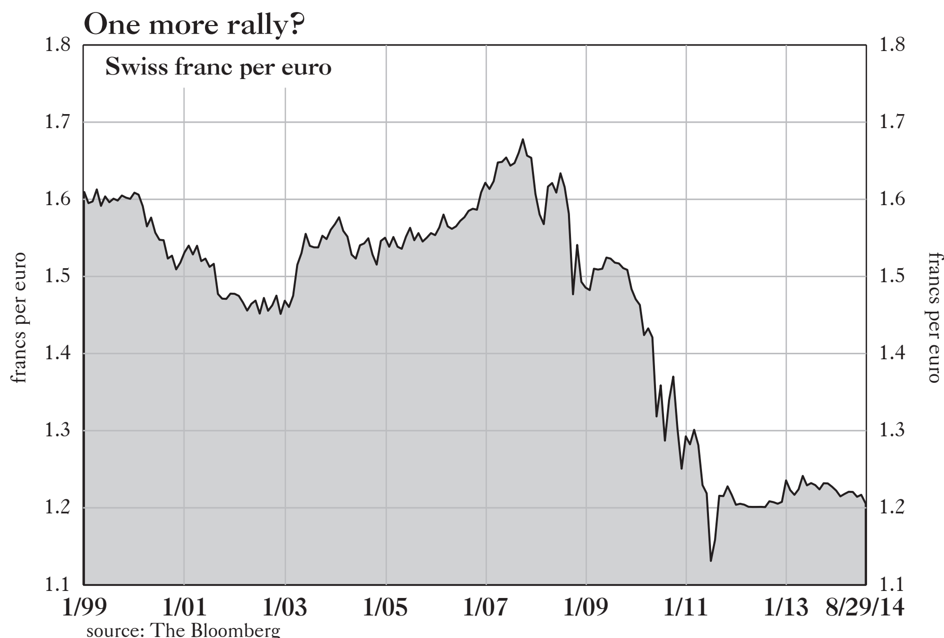
ANDROID APP ON Google play

Download from Windows Store

Google Play is a trademark of Google Inc.

Available on Windows Store

Apple, iPad, iPhone and iPod touch are trademarks of Apple Inc., registered in the U.S. and other countries. App Store is a service mark of Apple Inc.



duced by taps on a keyboard) and with that scrip buy ownership interests in real businesses. The equities are genuine. The money, legally and practically speaking, is itself real—you never mind having a little more of it. But what is its substance? We mean, how is it different from air?

In any case, observes colleague Evan Lorenz, the scale of the Swiss operations is titanic. He reports that, from December 2007 to July 2014, the SNB's balance sheet expanded to the equivalent of 83% of Swiss GDP from 23% of Swiss GDP. For perspective, over approximately the same span of years—and after three successive QE programs that boosted the Federal Reserve's assets by $3.5 trillion—the Fed's balance sheet as a percent of U.S. output expanded to 25% from 6%.

Swiss interest rates have shriveled as the SNB's balance sheet has grown. Thus, in January 2008, the average rate on 10-year, fixed-rate mortgages was an already low 4.17%; as of June 2014, 10-year loans were offered at an average of 2.25%. "In other words," Lorenz points out, "Swiss homeowners can borrow more cheaply than Uncle Sam." They can and they do. From December 2007 to June of this year, Swiss mortgage debt as a share of GDP surged to 146% from 127%. (Between the first quarter of 2009 and the first quarter of 2014, chastened Americans reduced America's mortgage debt as a share of American GDP to 55% from 74%.)

In these stupendous interventions, the SNB is hardly unique. Nor is it alone as it attempts to undo, through administrative means, the distortions it creates through monetary policy. New "macro-prudential" directives have tightened standards for home-loan amortization schedules, minimum down payments, affordability, bank capital ratios, etc.

Though the UBS Swiss Real Estate Bubble Index continues to flash "risk," the mortgage market cooled a bit in the first half of the year, Philippe Béguelin, an editor at *Finanz und Wirtschaft in Zurisch*, advises Lorenz. Then, too, the foreign exchange market cooled late in 2013, which allowed the SNB to cease and desist from franc printing. Thus, the central bank's assets declined to CHF 492.6 billion in February from a peak of CHF 511.7 billion in March 2013.

Russia's accession of Crimea at the end of February reheated the forex market. ISIS and the Scottish referendum have continued to turn up the temperature. Business activity in China continues to dwindle (electricity production fell 2.2%, measured year-over-year, in August), and European growth registers barely above the zero line. On Sept. 4, Mario Draghi unveiled a plan for a kind of euro-zone QE. So growth in the SNB's balance sheet has resumed. In July, the latest month for which figures are available, footings reached CHF 517.3 billion in July, a new high.

"If the drumbeat of bad news continues, why wouldn't investors move more cash into Switzerland?" Lorenz inquires. "Successive rounds of easy money have made the opportunity cost of parking assets in Switzerland much lower today than at the outset of the SNB's currency ceiling. True, the Swiss 10-year yield has declined to 0.49% from 0.93% since Nov. 1, 2011. But yields on the Irish, Spanish and Greek 10 years have also plummeted—to 1.88%, 2.33% and 5.69%, respectively, from 14.08%, 7.62% and 37.1%, respectively, at their euro-panic peaks. It no longer avails the income seeker much to gamble on second- and third-tier sovereign credits. Swiss yields are at rock bottom, but so are the rest of them. On the combined, undoubted authority of Deutsche Bank, Business Insider and Bloomberg, Dutch yields stand at a 500-year low."

It's a funny old world when frightened people turn to the Swissie, which the SNB is again mass-producing, rather than to gold, which nobody can mass produce. While the franc yields something to gold's nothing, the spread is narrowing. And if as Thomas Moser, an alternate member of the SNB's policy-setting Governing Board, suggested in a Sept. 10 interview with *The Wall Street Journal*, the SNB finally has recourse to negative rates, the barbarous relic will outyield the franc. Way back in the 1970s, relates Christopher Fildes, a delegation of foreign newspapermen were visiting the old Union Bank of Switzerland in Zurich. In response to a casual remark about the proverbial strength of the franc, a Swiss banker scoffed. "We do not say 'as good as gold,'" declared this eminence. "Gold is not as good as the Swiss franc." And now?

A bet on a higher Swiss/euro exchange rate implies that the SNB will stop intervening. What monetary or political forces might converge to persuade the bank that a strong franc is the lesser of two or more evils? "John Bull can stand anything but he can't stand 2%," the saying goes. It's clear to listen to their anguished cries that broad segments of the life insurance industry can't stand one-half of 1%. The Tokyo Stock Exchange TOPIX Insurance Index is essentially unchanged since 1994, the year that Japan government bond yields began their inexorable slide. "We are the collateral victims of the monetary policy which has been designed to help governments and banks after the financial crisis," Denis Kessler, the CEO of Scor SE, the world's

fifth-largest reinsurer, complained at a London conference on June 24. "We were not at the heart of the crisis nor did we create the crisis."

More money printing or sub-zero rates may once again set a fire under Swiss house prices, macro-prudential policies notwithstanding. It may ruin the life insurers. At some point, the Swiss National Bank would have to decide whether propping up the export sector is worth the cost. If these circumstances, a bet (and, to be clear, it is very much a bet) on the franc appreciating against the euro might pay. A three-year, at-the-money option on the franc appreciating against the euro is priced at 3.7% of notional today according to Bloomberg. To return to its high of 1.03 francs per euro on Aug. 10, 2011, the franc would appreciate by 17%.

While there is nothing especially exotic about this option, it is available only to institutional investors with an International Swaps and Derivatives Association agreement in place with a too-big-to-fail bank. For readers not so situated, there is always gold, which—in our opinion—the franc is no longer as good as.

Final last gasp?

(January 9, 2015) When Britain's pound sterling was as good as gold, His Majesty's government thought itself fortunate to be able to borrow at 3% in perpetuity. That was in 1751. Now that the pound is as good as pixels, George Osborne, chancellor of the exchequer, has announced his intention to avail himself of the opportunity to refinance those ancient 3s at interest rates even lower than 3%.

Trying to comprehend the 21st century's affinity for digital wampum, on the one hand, and ultra-low bond yields on the other, monetary historians of the future will scratch their heads till their brains ache. They will conclude, as we do here and now, that the world was bond mad.

"Whither rates?" is the question of the hour. Lower and lower, says Van Hoisington, the great bond bull, with whom we spoke on Monday (Hoisington's fund was up 32.6% last year; over the past 10 years it has delivered 8.62% a year vs. 4.71% for the Barclays Capital U.S. Aggregate Bond Index). Lower and lower in a crescendo of panic, say we. More from Hoisington below.

"Economists don't forecast because they know," quipped John Kenneth Galbraith. "They forecast because they're asked." Each month, Bloomberg asks dozens of economists to forecast the 10-year Treasury yield over a six-month horizon. On Dec. 11, the date of the latest survey, 71 economists responded. Each and every one predicted higher yields. One hundred percent were bearish on bonds.

"One last gasp for Treasurys?" was the headline over the page one article in *Grant's* exactly one year ago. In it, we suggested that Treasurys might confound the bearish consensus (though only 86% of the economists were then bearish) with an unscripted rally.

With this sequel, "One final last gasp?" we come close to repeating ourselves. Treasurys will continue to rally in 2015, a move that will culminate in even higher prices and even lower yields. And that will be the end of the bond bull market that started on Oct. 1, 1981, say we (and not for the first time, let the record show).

Though we expect a blow-off rally in government securities, "bullish" on Treasurys we're not. Bulls want to own the objects of their desire. Your editor owns no Treasurys and wants none. He owns no sovereign bonds of any maturity. Long-dated Treasurys may be cheaper than foreign government securities of similar duration, and the United States may be John Winthrop's "city upon a hill." But the bonds of any government are promises to pay interest and principal in a currency that the issuing government either creates or (in the case of European borrowers) lends a hand in creating. As government-issued money tends to depreciate, so should—over time—the value of the government's promises.

One makes allowances for price and value. Even a goldbug could be bullish on 14% Treasurys (*Grant's*, July 16, 1984). By way of reciprocity, perhaps, even a bond bug might see the merits of gold today, given the fact that the virus of radical monetary policy is swimming in the global political bloodstream; what feats of money printing will the central bankers attempt next time? On Tuesday, the Swiss 3s of January 2018 were priced to yield minus 29.3 basis points. Principal continuously invested at that rate of return is halved in 236.2 years. So it has come to pass that sterile gold is a high-yielding asset.

On form, interest-rate markets are long-trending markets. In 19th century Britain, gilt yields fell for 80 years. In 20th century America, Treasury yields rose in the 35 years from 1946 to 1981. Yields have fallen in the 33 odd years since 1981. Well do we recall the blow-off phase of the great bond bear market. Though economists strained to furnish reasons to explain why 15% was, after all, not so very high, given (for instance) the terrible Reagan fiscal prognosis, the real motive force in the bond market was panic. We wonder if the investment narrative spun today to explain the reasonableness of sub-1% yields on 10-year government notes will wear any better than the inflation-phobic yarns of the early 1980s.

These are historic times, we are certain. Chancellor Osborne's press release last month held out hopes for the prospective refunding of the perpetual 2 ½% securities issued in the fall of 1946 by the Socialist Chancellor Hugh Dalton. Cheap money was the cry on both sides of the Atlantic at the time. At Dalton's death in 1962, his epony-

To duplicate 2014 returns, yields must plumb lower lows

bond	total return in 2014	2014 year-end y.t.m.	assumed year-end 2015 y.t.m.*
U.S. 10-year Treasury	10.6%	2.10%	1.17%
U.S. 30-year Treasury	28.9	2.73	1.60
German 10-year bund	14.9	0.38	-1.08
Mexican 100-year bond	21.7	5.32	4.58
10-year gilt	14.4	1.66	0.22

*to match 2014 performance
source: The Bloomberg

mous 2 1/2s changed hands on a 6% basis. At the bottom in 1974-75, they had sold down to an 18% basis. "Daltons," those loss-producing pieces of paper were derisively called. The chancellor himself bought some; he died poor.

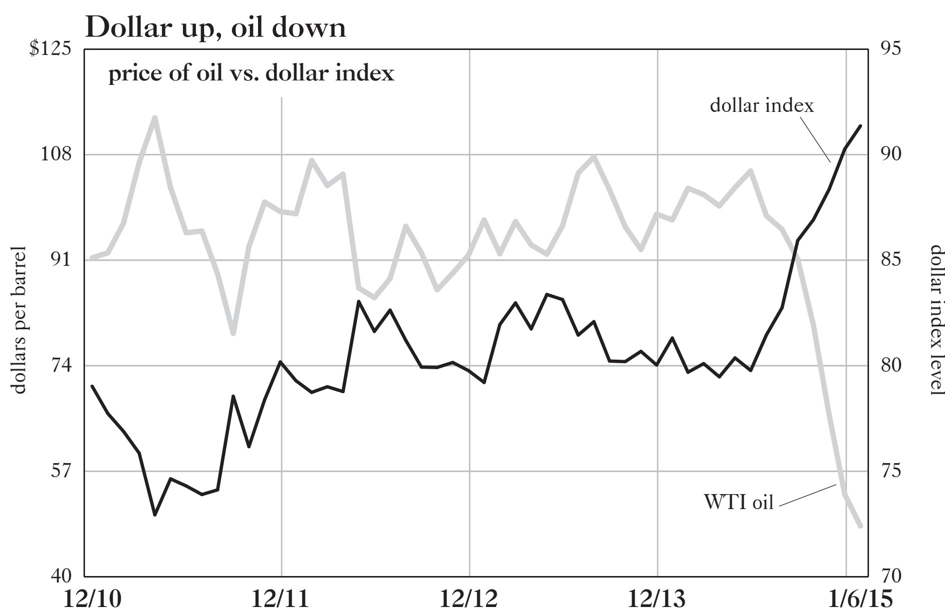
What's a fair yield for long-dated Treasurys? We put the question to Hoisington, who has held long bonds through thick and thin—mostly through thick—since October 1990, when they fetched 8 ¾%.

He replied with the proposition that inflation expectations are key. Look around the world, he said. You see a half-dozen countries whose 30-year debt trades at less than 2%—Denmark, Switzerland (0.541%), Japan and Belgium among them. "Their credits are in many cases much worse than ours. So you would argue that it's not the credit quality, but it's the fact that they have very low inflation and maybe some idiosyncrasies in those countries."

"So with that as a start," Hoisington went on, "what is the appropriate level for long-term rates in the United States? If the general trend which started in 2011 of lower commodity prices continues to be under downward pressure because of excess global capacity, then you would presume that U.S. prices would tend to have downward pressure as well. And you would assume that the stronger dollar, as everybody tries to get out of the muck around the world by devaluing their currencies against the dollar and the dollar continuing to appreciate, would put further downward pressure on prices. So we have a global phenomenon that is probably more impactful on the United States than in the past, and it seems to me to be pointed in the direction of downward pressure on prices. Whether that ends ultimately in 'deflation' is unknown, but certainly the prospect of a rapid rise in inflation seems, for the time being, not on the horizon."

In other words, "lower" is still the prevailing direction. Hoisington demurred on the notion that digital technology was a force for everyday low prices. Debt, however, he said, certainly weighs on prices: "We believe the fact that over-indebtedness of the United States and the world is contributing to the lack of global demand, because people have borrowed and spent, and that means they can't spend that money in the future, they have to try to repay it. And that's at all levels—corporate, individual, governments—and that is sort of an overarching restraint on economic activity. And the wonderful thing is that the Federal Reserve and other central banks can do nothing about it."

So more credit formation—induced by zero-percent borrowing costs—is not the way forward? we asked, leading the witness. "More debt is of course not the answer," Hoisington replied, "because it just brings forward consumption and makes it worse later, so they might be able to have a transitory improvement, but not a permanent improvement. The fact is, it seems to me, that the evidence in Japan and here in the United States that the effort to buy securities to help the system was counterproductive, and we would suppose if the ECB were unintelligent enough to try their own, that it would be equally unproductive. Somebody pointed out that almost all maturities are close to five years and they don't really have much long paper, so if they did do it, they'd be buying five-year notes, which are zero anyway. Or less than zero."



source: The Bloomberg

To duplicate the brilliant returns of 2014, 30-year Treasury yields would have to fall to 1.60%, 10-year gilt yields to 0.22%. "From a market standpoint," Hoisington commented, "with the Bloomberg survey continuing to show 100% of the economists forecasting higher rates for the umpteenth consecutive month, you have to assume the positions are still pointed towards people expecting higher rates, and for that reason the first part of this year could see really much lower interest-rate levels than anyone thinks possible, because of positioning in my opinion."

Assets under management at his firm ended the year at $6 billion, Hoisington related. Though it's a new high, clients are hardly breaking down the doors to get in: "Everybody still thinks rates are going up, and this would be a stupid time to invest in 30-year bonds."

Business activity is weaker than the Fed seems to know or to acknowledge, Hoisington went on: "We think this year will be slower than last year in terms of growth, and nominal growth will be noticeably slower. Real growth will be slightly slower. So when we see that, if the Fed were to raise rates in a weakening environment, which is what they would be doing, I think bond rates would rally…." And if the economy surprises to the upside? Even then, Hoisington said, the long end of the yield curve would probably rally: "It would be the last hurrah for a moment."

Our ears perking up at the phrase "last hurrah," we mentioned some of the signs of panic and—in the case of the proposed British refunding—of historic optimism we see. Is it possible that the market has overdone it?

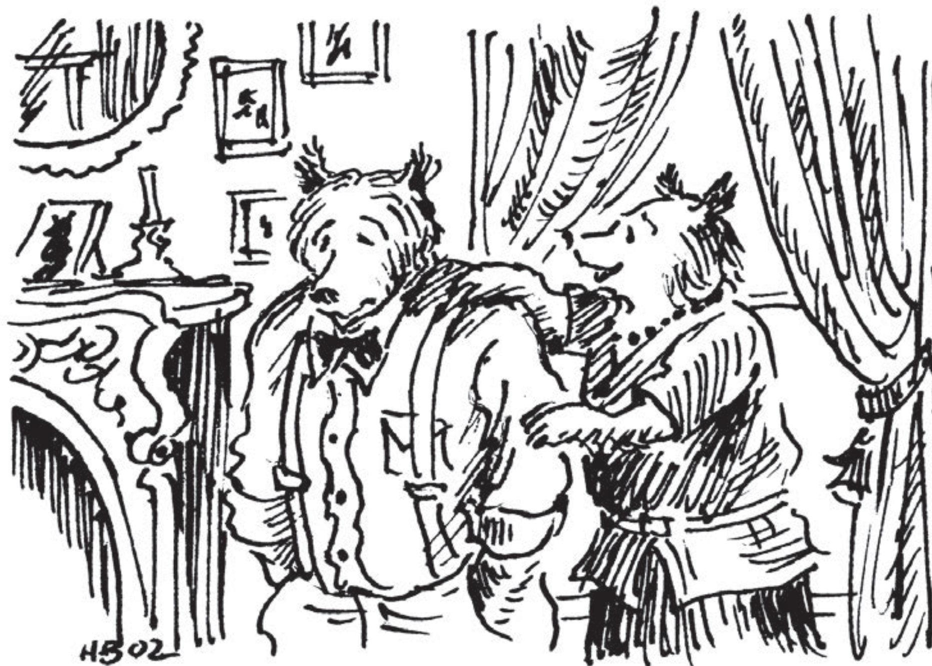
"If you look back in United States

New York will come to you!

Grant's is Webcasting the Fall 2015 Conference on October 20.

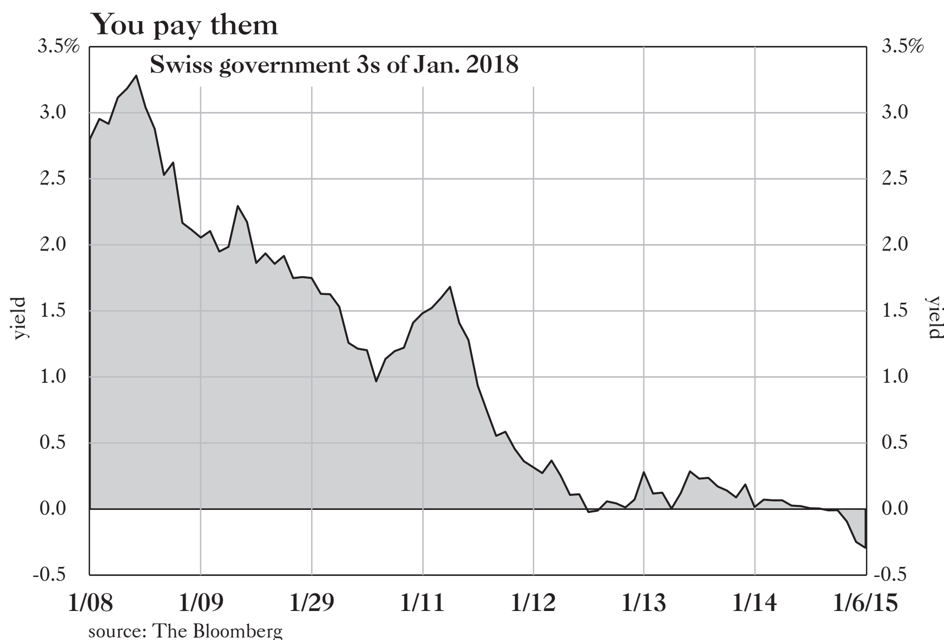
Of course, nothing's better than being at the Plaza Hotel yourself (who are you going to meet while staring at your iPhone?). Next best thing is our day-long Webcast—live. And if you should happen to miss the live event, on-demand viewing is yours, too. It will be available just a few short days after the conference wraps up.

In person: $2,150, includes breakfast, lunch and cocktail reception.
Webcast: $1,750 gets you the complete virtual experience, including the ability to participate in a live Q&A.
Register now at www.grantspub.com/conferences.



"Cheer up, Herbert!
Grant's is Webcasting the Fall Conference!

Questions? Please call 212-809-7994 or email conferences@grantspub.com



history, our charts going back to 1870, the market spent a few years below 2%, but not much and not by much," Hoisington replied. "And so having 30-year rates below 2% seems to me to be excess. We're not there yet, but in a very short period of time we could be."

And if that were to come to pass, the collapsing energy markets would bear a good share of the blame (or, from the bond bulls' vantage point, credit). People understandably focus on the bulge in supply, said Hoisington; they should not overlook the evident crack in demand. "The demand curve can shift out and take these oil prices even lower than they are today, in our judgment," he went on. "And we think that has an enormous impact on economic activity. In 1986, 1985, we had oil go in round numbers from $40 to $10, maybe a little below that. We actually had a mini recession. I think they may have revised that away but we had one quarter down in 1986. So we think the drop in oil prices is a clear negative to the United States economy this year. The high-paying jobs were in the oil sector. We know that about one-third of the increase in capital spending over the last four years was due to oil, but there was a knock-on effect, so we figure instead of 30%, it's roughly 45% of the increase in capital spending was due directly or indirectly to this oil boom. So we think there's a major adjustment economically from this downtick in oil prices in the United States—it is going to be enormously disappointing over the next six to nine months."

Hoisington wound up on a note of prospective—underscore the word "prospective"—bond-bearishness: "If you get the right set of policies, things can turn around in a hurry," he said. "And people forget this. We've had this sort of pendulum swing towards overregulation, constraining small banks from lending, being anti-business, and it's possible the pendulum starts to swing the other way, and business has been lackluster for so long that, in my judgment, a shift in regulatory policy and tax policies could create a substantial boom by the private sector in the U.S. and therefore around the world. So I'm not overly pessimistic, but for the time being, we have anti-growth policies in place."

Revenge of the reciprocal

(May 1, 2105) Finance is nothing if not symmetrical. There are assets, and there are liabilities. There is demand, and there is supply. For every policy yin, there is a policy yang. The unscripted consequences of post-2007 monetary intervention is the subject at hand.

We conclude, skipping right down to the bottom line, that radical policy is here to stay. We so judge because the Fed's newfound M.O.—ostensibly a bulwark against financial instability—is itself inherently destabilizing. Look no further than the life insurance business, the oil market or the pricing of "high-yield" debt. One episode of QE tends to set up a clamor for another, and then another. Besides, the mandarins demand, what's the harm? Where's the inflation?

A crack-up, say, in the European life insurance industry (brought about by Mario Draghi's vanishing interest rates) or a bankruptcy-inducing plunge in some oversupplied commodity market (instigated by producer access to ultra-cheap finance), would surely spark new rounds of aggressive central bank action. It would make no difference that the not-so-remote cause of the trouble was monetary policy itself. The Fed's functional dual mandate has become that of arsonist and fireman.

The central bank, though it is well aware of the existence of financial liabilities, never seems to mention them. Asset inflation is what the banks of Bernanke and Yellen set out to achieve. Unavoidably, they also achieved liability inflation, its reciprocal.

Like assets, liabilities have values, even if we customarily think of those values as burdens. The lower the discount rate, the greater the liability. The greater the liability, the more collateral it takes to satisfy the contractual commitment to pay savers, annuitants and pensioners, observes Sean McShea, president of Ryan Labs Asset Management. A simple example will illustrate. At a 6% yield, $1 million in principal will earn you $60,000 a year. At a 3% yield, you'll need $2 million to provide the same income. "The rising cost of retirement" is another way of saying "the rising value of liabilities."

The bull market in liabilities is the source of the bear market in life insurance. "Germany's life assurers: the next crisis?" was the headline over the April 21 *Financial Times* report on the gathering clouds over *Lebensversicherungsgesellschaften*, as a thrifty burgher would call the indigenous life business. Some 90 German life insurance companies with €900 billion of assets under management are panting for the interest rates that Mario Draghi's Europe does not provide. (On Tuesday, Bloomberg flashed news that an issue of securitized Spanish business loans had stopped paying interest because Euribor, the euro-denominated three-month interbank offered rate, had dropped below zero to minus 0.005%.)

"[G]uaranteed rates far outstrip today's meager investment returns," the *FT* reports of the German life companies. "Although new policy guarantees are capped by law at 1.25%, the long tail of policies—which typically extend for 30 years—means average guarantees are still running at 3.2%. Compare that with the 0.14% yield on 10-year bunds, and the tension becomes obvious."

The tension is pan-European. According to the IMF's new report on financial stability, or rather the lack of it, "more than half of European life insurers are guaranteeing an investment return to policyholders that exceeds the yield on the local 10-year government bond, thereby incurring undesirable negative investment spreads."

Which points to a "high and rising risk of distress" among mid-size companies, the IMF analysis continues. The failure of one could trigger a loss of confidence among many, "if the failure is believed to reflect a generalized problem. . . . The high and rising interconnectedness of the insurance industry and the wider EU financial system is another source of potential spillovers. The industry has a portfolio of €4.4 trillion in EU credit. Furthermore, insurers are traditionally closely linked to banks through liquidity swaps and bank bond holdings. . . . A large mark-to-market shock could force life insurers into asset reallocations and sales that could engulf the financial system." No surprise, then, that income-seekers have pushed half of euro-denominated BB-rated bonds—the highest rank of speculative grade, but still junk—to yields of less than 2%, according to the April 13 edition of the *Financial Times*.

The bull market in liabilities is raging on both sides of the Atlantic. In 2014, the defined benefit pension plans of the 100 biggest American corporations lost actuarial ground despite an average 9.2% gain in their average assets, according to the annual tally by *Pensions & Investments*. Liabilities gained more value than assets did, owing to a drop in the assumed average discount rate to 4.05% from 4.82% in 2013. People are living longer, too, but—as a matter of causation in the liabilities world—QE easily trumps the revised mortality tables.

Radically easy money was supposed to expand aggregate demand by making the holders of assets feel richer. So stimulated, this vanguard of consumption would ostensibly spend until the economy achieved "escape velocity."

If theory said one thing, practice has revealed another. It's a world—to quote page one of Saturday's *Wall Street Journal*—"awash in too much of almost everything." Here was another kind of stimulus, no less effective because the central bankers didn't plan for it.

Oil, cotton, iron ore, labor and capital are all in surplus, the *Journal* reports, "a glut that presents several challenges as policy makers struggle to stoke demand." Like traffic and weather, or love and marriage, demand and supply are nearly inseparable. In trying to boost demand, the central bankers have inadvertently fired up production. Energy is Exhibit A.

Over the past decade, observes the new edition of Deutsche Bank's annual study of junk bond defaults, energy was the fastest-growing segment, both of America's economy and America's capital markets. "Energy issuers," according to the DB analysts, "now represent the single largest sector in the U.S. high-yield market, the second largest in U.S. investment-grade (after financials) and the third largest in U.S. equities." Without money both cheap and abundant, it is hard to imagine the shale revolution taking the shape it did—nor the price of oil taking the kind of pratfall it has.

Now, a low oil price may be a gift to humanity. A collapsing oil price in the context of a leveraged oil industry is another matter. So, too, is a collapsing oil price in the context of an idée fixe that "deflation" is a peril that must be met with aggressive reflationary action. Said action can't help but distort some of the prices that the mandarins didn't think to include in their macroeconomic modeling. More distortion, and greater instability lead to more intervention, i.e., to still more distortion and instability.

"The current state of plenty is confounding on many fronts," the *Journal* story continues. "The surfeit of commodities depresses prices and stokes concerns of deflation. Global wealth—estimated by Credit Suisse at around $263 trillion, more than double the $117 trillion in 2000—represents a vast supply of savings and capital, helping to hold down interest rates, undermining the power of monetary policy."

We wonder how much of this bruited cornucopia is "capital" and how much is debt. Capital is savings, or consumption deferred; you don't have to pay it back. Credit is like a library book; you must return it by the due date. As to the "power of monetary policy," we judge that it's just as potent as ever. The rub is the results it achieves. They're not always the ones the policy makers intended.

Show everyone how smart you are...

Own a print of a Hank Blaustein masterpiece.

"But Daddy, you were so smart yesterday."

5"x 5" cartoon size.
Signed by Hank,
matted and suitable
for framing, $150.

Find your favorite
in the *Grant's*
cartoon treasury!

Go to
www.grantspub.com
to order.

WWW.GRANTSPUB.COM/CARTOONBANK

If the makers of QE meant to seed a bull market in junk bonds, they've outdone themselves. Jim Reid, Deutsche Bank's high-yield strategist, relates that so far as the 2010-14 cohort of high-yield debt is concerned, defaults are the lowest since the start of modern record-keeping in 1983. Practically (this is *Grant's* talking now), companies aren't defaulting because the market, priced as it is, won't let them, though the market may soon have to reconsider. At $50 per barrel oil or less, the DB analysts reckon, each and every high-yield oil and gas issuer rated single-B and below will register negative free cash flow.

The paucity of defaults is, to our mind, no badge of honor but another proof of policy gone wrong. In the capitalist forest, old growth must perish to let the new growth find the sunlight (without which the denizens of the forest soon find themselves speaking Japanese). Besides, businesses that survive solely by the indulgence of their creditors aren't destined to prosper once easy money becomes hard to get.

The Federal Reserve Bank of Boston has published a new paper which takes the view that the Fed ought not to abandon QE but keep it handy for the next cycle of distress. "The author's view," concludes author Michelle L. Barnes, a Johns Hopkins Ph.D. and senior economist in the bank's research department, "is that balance sheet tools in practice have led to benefits not available from using the federal funds rate tool alone, particularly because none of the feared costs from using these newer tools have yet materialized." Be patient, we would counsel in this context; "feared costs" can take their own sweet time to materialize (as Paul Singer was quoted as saying in these pages two weeks ago).

"To add value to society," Barnes proceeds, "the best action that the Fed can undertake is to do what is needed to execute appropriate policy, however that end is reached. Foregoing the use of potentially valuable policy tools because such tools are unconventional and the full cost and benefits as yet unknown seems to miss the point entirely. . . ."

Radical improvisation works, the economists cry. Let us therefore have more of it. And there will be more—on this, at least, *Grant's* and the Ph.D.s see eye to eye.

•

NEW this conference:
Webcasting the full day's events!
Go to grantspub.com/conferences

GRANT'S

Fall 2015 Conference

Tuesday, Oct. 20, 2015 ✧ The Plaza, Manhattan

Martin Wolf,
***Financial Times* economics columnist,**
debates
James Grant:
"Resolved: Monetary experimentation has gone dangerously far."

Speakers include:

Wences Casares,
Xapo
Jim Chanos,
Kynikos Associates, LP
Stanley Druckenmiller,
Duquesne Family Office, LLC
Thomas S. Gayner,
Markel Corporation
John Hathaway,
Tocqueville Asset Management
James Litinsky,
JHL Capital Group
Michelle Leder,
Footnoted.com

Avoid disappointment! Register online now.

In person: $2,150, includes breakfast, lunch and cocktail reception.
Webcast: $1,750 gets you the complete virtual experience, including the ability to participate in a live Q&A.
For information, call 212-809-7994, during business hours.

Register or download a form at www.grantspub.com/conferences

No Plugin, No Problem.

View and print hassle-free in FLASH.

Open it

Click
“View in Flash”

Print it

Click here

www.grantspub.com

Operation Barn Door

(March 20, 2015) Incapable of predicting financial crises, our central bankers are doing their all to prevent them. Should you rest easier on that account? You should not, to anticipate the conclusion of the essay now in progress.

Citigroup, of all the accident-prone institutions, last week passed a Federal Reserve-administered stress test with flying colors. What does this fact tell us? It tells us less about the bank (which spent more than $180 million on cramming and test prep) than it does about the Federal Reserve. Long on process but short on imagination, our mandarins strain to understand the nuanced nature of financial risk.

The view from *Grant's* is that risk can usually be found where you aren't looking for it. You get to thinking, for example, that government bonds are perfectly and unconditionally safe. You would so conclude after 33 ½ years of a bond bull market. Yet, the same asset struck many as perfectly and unconditionally unsafe at the 33 ½-year point in the preceding 1946-81 bond bear market. Nothing in investing is for certain or forever. "Many shall be restored that now are fallen, and many shall fall that are now in honor," wrote Horace (65 B.C. to 8 B.C.), anticipating the "dogs of the Dow" approach to stock selection.

You can move risk from here to there—from one kind of institution or one kind of asset to another—but you can't eliminate it. You may think you know what it is, but it turns out to be something else. Citibank, index case of management incompetence turned star test-taker, lifted its nominal exposure to derivative contracts to $59 trillion in 2014 from $39 trillion in 2009. Were derivatives on the test?

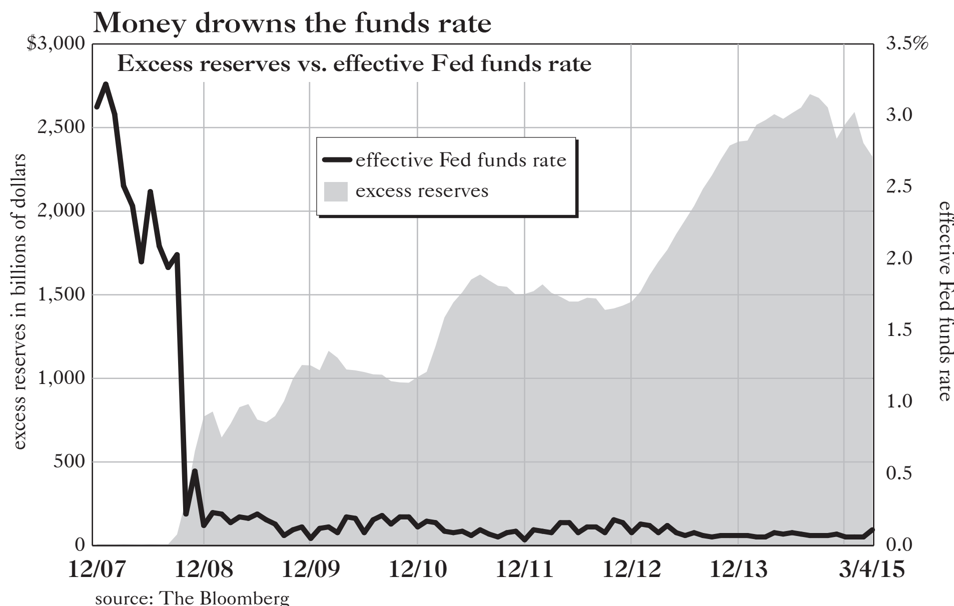
Or, to quote the learned Andrew Haldane, chief economist of the Bank of England: "Risk, like energy, tends to be conserved not dissipated, to change its composition but not its quantum. So it is possible the financial system may exhibit a new strain of systemic risk—a greater number of higher-frequency, higher-amplitude cyclical fluctuations in asset prices and financial activity, now originating on the balance sheets of mutual funds, insurance companies and pension funds." In other words, by making the banking system safe—if, indeed, it succeeds in that mission, which we doubt—the Fed may only succeed in making other departments of American finance unsafe.

Fractional reserve banking is risky business even in a setting of positive real interest rates, un-manipulated asset markets and stable exchange rates. It can't be any easier in a setting of negative real interest rates, governmentally swollen asset values and drunkenly oscillating exchange rates. With one hand, the Fed is manipulating interest rates, therefore the value of the myriad financial claims tied to interest rates. With the other hand, it's trying to impose safety and soundness from on high. Left hand and right hand are working at cross-purposes.

"[W]e are all macroprudentialists now," Federal Reserve Governor Daniel K. Tarullo preached to a choir of financial regulators who assembled in Arlington, Va., on Jan. 30 to advance the cause of safety by government fiat. We are, in fact, not quite all macroprudentialists now. The fixers of interest rates and raisers-up of financial assets—which is to say Tarullo's colleagues on the Federal Reserve Board, at the European Central Bank and at the Bank of Japan—are the unwitting enemies of macro prudence. If price control is a policy that tends to backfire on the governments that implement it (and it is), and if interest rates are among the most critical prices in finance (and they are), 21st century monetary policy is riding for a fall.

Some may protest that interest rates would be just as low in the absence of ZIRP and quantitative easing as they are with them. We can't prove them wrong. We rather observe, for instance, that Treasury yields were higher in the Great Depression than they are today, and that in the wake of the announcement by the ECB that it, too, would begin a massive bond-buying program, the yield on the 10-year German government yield tumbled by 20-odd percent on March 9 and by another 20-odd percent on March 10 ("a market first I am sure," dryly remarks reader Paul Isaac). These precious German pieces of paper are currently priced to yield 0.28%. So we conclude (*a*) that yields are in fact artificially depressed and that (*b*) a future snapback in interest rates will rattle the investment teacups. From which it follows that, in their drive to avoid a repetition of the previous financial crisis, the central bankers could be propagating the next one.

You may say give the regulators credit for trying: Would you have them do nothing? Or you may say, the bankers had it coming: They almost sank the institutions that overpaid them. Besides, the counter-argument could run, it's unhelpful to dwell on problems that seem so well discounted. Monday's *Financial Times* reports



that certain asset management companies are already rehearsing for the next downdraft in bond prices, a selloff which they anticipate will be made especially costly by the illiquid condition of the market. Nor is it exactly front-page news that banks are in bad odor with investors: In relation to the S&P 500, the S&P bank index sits at a post-1941 low (this according to an eye-opening chart book that Michael Hartnett of Bank of America/Merrill Lynch will distribute and read from during lunch at the April 7 *Grant's* Conference —advt.).

Yes, we reply, credit to the regulators for their (misplaced) zeal, and shame on the crony capitalists who, operating in the quasi-socialized industry of too-big-to-fail banking, mismanaged their institutions to the point of failure. If it were up to us, we would restore the capitalistic state of things in which the stockholders of a bank got a capital call if the institution in which they owned a fractional interest became impaired or insolvent. That is by the by. We write to call attention to the changes that the Tarullo-led regulatory drive is effecting in the landscape of finance. "It can't be," the head of the Nordic region's biggest bank, Christian Clausen, CEO of Nordea, told the *Financial Times* last fall, "that the only purpose of banking is to stop banks from going bankrupt." Clausen should tell it to the feds.

Complex financial institutions are hard to manage, we are forever being told. The bankers struggle to understand them. Do the regulators understand them better? How many members of Tarullo's macroprudential battalions have ever managed a bank? If complex financial institutions are unmanageable, how can the sidewalk superintendents presume to manage a "system" of the same?

In the issue dated Jan. 23, *Grant's* quoted Richard Bove, analyst with Rafferty Capital Markets, to the effect that the government has virtually nationalized the banks. "By that I mean," said the analyst, "basically the government tells the banks what the size of their assets should be. If they go above those sizes, the government hits them with capital penalties. Then the government says OK, we're going to tell you how to allocate your assets between loans and other areas. And then the government goes into liquid assets and says, 'Well, these are high-quality liquid assets and these are not'. . . and it goes into your loan portfolio and it tells these banks, 'this is where we're going to allow you to have low-risk weightings and therefore we want you to lend there, and this is where you can't lend.'"

You start to wonder where regulation leaves off and management begins—or if the regulators showed up for work one day while the managers stayed home, whether anyone would notice the difference. Thus, the Fed has pushed banks and money market funds into government securities, and thereby disadvantaged privately issued claims. It has made big banks jump through hoops of stress tests, and so distracted those institutions from the quotidian business of making a living. It has driven big financial institutions out of market-making at the cost of draining liquidity from the fixed-income markets.

Congress enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 to shut the door on frenzied finance (the bulls having already bolted from the barn). No more would Washington confine itself to regulating markets and institutions one by one. It would turn its attention as well to the "system"—"safeguarding financial stability by containing systemic risk," as Tarullo put it to his federal confreres in January.

To forestall a recurrence of the events of 2007-09, the Fed, in harness with a pair of new Dodd-Frank creations, the Office of Financial Research and the Financial Stability Oversight Council, would regulate from the 10,000-foot level as well as at ground zero. The grand plan was—and remains—to eliminate bank runs, liquidity crises and "fire sales," by which the federal guardians would appear to mean "bear markets."

And just how does the government propose to achieve a state of noncombustible finance? Why, it will nudge or shove private actors into approved assets and managerial techniques. The Volcker Rule dispenses with most proprietary trading. The Dodd-Frank Act Stress Test, the Net Stable Funding Ratio (yet to be finalized), the Comprehensive Capital Analysis and Review and the Comprehensive Liquidity Assessment and Review will, under the oversight of the Federal Reserve's Large Institution Supervision Coordinating Committee, supposedly protect the world from the kinds of blunders that made 2008 such fine newspaper copy. And if all else fails, a bankrupt bank can be wound up according to the instructions contained in its own living will (another Dodd-Frank innovation).

Let us see about the consequences of these various policy demarches. The bond market is one early macroprudential casualty. Dealers aren't dealing as they did, and trillions of high-grade securities repose on the central banks' balance sheets rather than in the hands of price-sensitive investors. Dan Fuss, vice chairman of

Loomis, Sayles & Co. and manager of the flagship Loomis Sayles Bond Fund, relates that for many a moon, one could sell $200 million to $250 million of Treasury securities without moving the market. Today, that limit is as low as $60 million. "Not only is it harder for the dealer banks to hold inventory for regulatory purposes," Fuss tells colleague Evan Lorenz, "there are fewer of the dealer banks than there used to be."

A fine mess it would be if, in case of an unscripted rise in interest rates, investors in mutual bond funds came running for their money all at the same time. Sell! they would cry, but to whom? Tarullo mused on this kind of scenario in his January remarks. "Considerable work is needed, first, to develop better data on assets under management, liquidity and leverage, in order to fill the information gaps that have concerned so many academics and policy analysts," he said. "Then there is more work to be done in assessing the magnitude of liquidity and redemption risks, including the degree to which those risks vary with the type of assets and fund structure. And finally, we will need tools that will be efficient and effective responses to the risks identified." In short, more regulation is what the doctor orders.

We mentioned the Net Stable Funding Ratio. It measures a bank's "stable" funding in relation to its overall funding. Stability is in the eye of the federal beholder. For the feds' money, most forms of wholesale funding don't make the grade. Repurchase agreements, for example, do not conform to the regulators' ideal; mainly short-dated, they presented problems galore during the financial crisis. The regulators weigh in, too, on the source of bank borrowings; money funds, in general, displease them. Not that the regulators positively forbid a bank from borrowing from a money-market mutual fund. Rather, a money fund's money generally adds nothing to the regulatory definition of "stable" funding.

While no such regulations are yet in place in America, they are thought to be coming soon. The rules will push banks to reduce their short-term borrowing and, whenever possible, to match the maturity of their assets with the maturity of their liabilities. Liabilities of longer than one year's duration will meet with particular regulatory approval.

Money funds, already neutered as to yield and regimented as to asset mix, will be further disadvantaged by NSFR. As it is, some 48% of money fund assets sit in bank-issued paper. Where will the money go come the arrival of formal NSFR rules and regulations? Not necessarily to a safer class of borrower.

You might have expected that the money funds would already be extinct. With assets of $2.5 trillion, they are still very much with us, though yielding an average of just three basis points pre-tax. People do still possess cash. For regulatory reasons, the big banks don't want it. The money funds accept it. What do they do with it?

"What you've seen, historically, is when money seeks to be invested, Wall Street finds a way," Peter G. Crane, president and publisher of Crane Data LLC, tells Lorenz. "It's like the *Jurassic Park* line, 'life finds a way.' Money finds a way. Maturity transformation is not a new business."

"Maybe," Lorenz speculates, "the money funds will beat a path back to asset-backed commercial paper, to which they were heavily exposed before the bust. Or maybe to Chinese banks or to industrial credits of various kinds. More likely, they will flock to the federal government. Fidelity Investments, for one, is converting its prime money funds into government funds—no more bank investments for them, just obligations of the United States. So it is that Fidelity Cash Reserve, which has $110 billion under its wing and yields one whole basis point before tax, is on its way to being rechristened Fidelity Government Cash Reserves."

Share *Grant's* with a click

As a susbcriber you can now easily e-mail any issue or article to a friend. Simply log in at grantspub.com and click on the SHARE> button.

"John, have you heard what Grant's is saying about Amazon... No?"

30 years of issues available online.
Go to www.grantspub.com

Don’t miss a single idea.

Forgot to highlight one of the companies in *Nature’s own bitcoin*? We’ve done it for you. Login to see if you missed any ideas in the current issue

Our **Investing Ideas** page lets you track ***Grant’s*** Investing Ideas with ease. Sort by company, ticker, issue and article or print a simplified list for future reference.

Don’t forget to log in for the full list of ideas.

www.grantspub.com/investing-ideas

Constant readers will recall the existence of a Federal Reserve RRP facility. The acronym stands for "reverse repurchase agreement," or, more colloquially, "reverse repo." The RRP is the Fed's receptacle for surplus cash. It came into the world in 2013 and owes its existence to QE. In December 2007, excess reserves—dollar balances over and above the sum that banks are legally obliged to keep idle—totaled $1.8 billion. Now they foot to $2.3 trillion. This enormous weight of money has marginalized the old fed funds market. The funds rate is zero (or nearly so) not just because the Fed, for now, wants it to be. It's as low as it is because the supply of lendable reserves overwhelms the demand for lendable reserves.

How, then, can the Fed raise the level of money market interest rates, assuming it ever wants to? For starters, it can raise the rate it pays on excess reserves, which is currently 25 basis points. For another, it can raise the rate it pays on money it borrows through the RRP facility, which is currently five basis points.

If you are scratching your head, keep right on scratching. It's not at all clear why the Fed would need to borrow dollars—for Pete's sake, it prints them. What it does need is to smooth over the distortions that QE has wrought. In building its $4.5 trillion balance sheet, the Fed removed—in round numbers—$3.5 trillion of notes, bills and bonds that would otherwise be afloat in the market. The Bank of Yellen may not need dollars, but the private sector periodically needs securities. Money funds, especially, feel the need. Today, the funds can lend against Treasury collateral at 22.9 basis points per annum. At other times—especially at quarter-end—no such opportunity presents itself and the fund managers fairly beat down the RRP's door. It's not so farfetched that, come the next financial pileup, the funds will go running to the RRP, to which no credit risk attaches, leaving the private sector in the lurch.

"As things stand," Lorenz notes, "the size of the RRP is capped at $300 billion. Let's suppose that the Fed expands it in the course of pushing interest rates back to normal. Say that it grows to $1.5 trillion. And say that a new crisis erupts. Money funds, looking to their own survival, would very likely yank funds from non-guaranteed borrowers and port them over to the Fed. Thus the net stable funding regimen, which was designed to make the system safe, could very well have the perverse effect of making the system unsafe."

In response to a reporter's question about the secret of his success, the turn of the 20th-century president of the old Chemical Bank, George Williams, responded, "The fear of God." Substitute, today, the fear of the government. Tarullo seemingly tries to think of everything. Similarly—as a reader of his recent speeches may conclude—it seems as if he were out to regulate everything.

But, of course, borrowing from Haldane, you can't regulate everything. At least, you can't regulate risk out of existence. You can only move it around. Christopher Whalen, senior managing director of Kroll Bond Rating Agency, takes the feds to task for allowing the banks to continue to expand the commitments and derivatives they park off-balance sheet. "The whole notion of 'off balance liabilities' is an oxymoron," Whalen, along with his colleague Joe Scott, write in a March 9 comment headed: "For Bond Investors, the Bank Stress Test Process is Beside the Point." "Why is any liability 'off balance sheet,' and if it is 'off balance sheet,' why is it a 'liability'? Nobody at the Fed, or other regulatory agencies it seems, can answer that question."

One regulatory push begets another and then another—as the liquidity coverage ratio initiative and net stable funding ratio have brought us something called the Comprehensive Liquidity Assessment Review. You listen to Tarullo acknowledging the mischievous power of unintended consequences and you think, "Aha! He's too smart to be doing what he seems to be doing." Perhaps, but he's doing it.

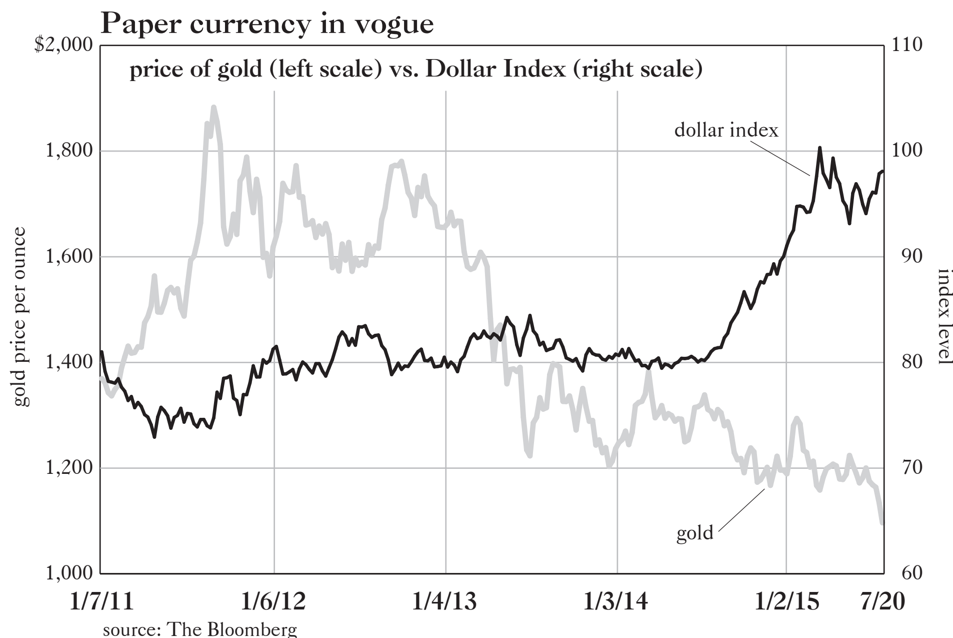
"Risk," writes John Adams in his wonderful 1995 book of the same title, "is constantly in motion and it moves in response to attempts to measure it. The problems of measuring risk are akin to those of physical measurement in a world where everything is moving at the speed of light, where the act of measurement alters that which is being measured, and where there are as many frames of reference as there are observers."

Markets provide innumerable frames of reference. A government-banking potentate brings one to the table. "Fire sales?" They are in our financial future.

•

International complacency contest

(July 24, 2015) Huge short sales in the slackest portion of the Monday trading session sent the gold price



down a fast $40 per ounce. It was double the value at which an ounce of bullion was fixed under law from the dawn of the American Republic until the early 1930s. Whither gold, whither the pure paper monetary system, and whither the gold stocks that this publication has been so unprofitably boosting are the subjects at hand.

"The Golden Constant" was the title the scholar Roy Jastram affixed to his history of the uncanny long-term stability of prices under the gold standard. For the next edition of that seminal work, his publishers may wish to consider a repositioning along the lines of, say, "The Golden Football." In the age of QE, you buy the precious metals for the rise, and sell them for the fall. You read about them in the commodity section of your daily paper. Seemingly, the legacy monetary assets have no greater monetary relevance than copper (which itself was recently the object of a wee hours bear raid).

The bears—right as rain since 2011—observe that whatever else gold may have to offer, it's denominated in dollars and pays no interest, which qualities make it doubly vulnerable to the start of a now seemingly imminent Federal Reserve tightening cycle. They contend that yesteryear's credit problems are well and truly history. What's in prospect, they say, is the continued liquidation of ETF investments that seemed to make sense only as long as the price of bullion was going up or—at least—not being kicked down flights of stairs in the middle of the night by mysterious short sellers in distant time zones.

The bears don't explicitly extol the policy-making competence of the world's central bank chiefs. They do praise it by implication. Necessarily, to be bearish on gold is to be bullish on the former tenured economics faculty members who guide the world's monetary destiny. It's to cast your financial ballot against the price mechanism, which the mandarins have been overriding. It's to vote for the proposition that this greatest of all experiments in money conjuring will end happily and profitably for the holders of financial assets.

The optimistic view of things (optimistic, that is, for gold) is that disillusionment with the theory and practice of 21st century central-bank management still lies in the future. For now, most investment professionals are prepared to lodge their trust (and their clients' net worth) in the powers and judgment of the central bankers. Wall Street loves the Fed, Japanese equity ETF investors love the Bank of Japan and the big European banks—especially the slow learners who stuffed themselves with Greek sovereign debt—love the ECB. A knowledgeable gold watcher estimates that all but a sliver of worldwide demand for physical metal emanates from Asia. "We will see real gold prices when G-7 investors wake up and decide they need to own real gold," our friend remarks. "All confidence games end in a loss of confidence, and so will this one. The preconditions have been in place, we are just waiting for a precipitant."

Observing that China is wobbling and commodity prices are sinking, you may ask: Is gold not depreciating against the dollar because deflation is knocking at the door? If deflation were defined as falling prices induced by desperate debts (a crack-up in the speculative-grade bond market, for instance), we would reply that, yes, deflation could be knocking. The comprehensive mispricing of credit under a regime of zero-percent interest rates suggests how rich are the possibilities for turmoil.

Which prompts another question: If a proper debt deflation ever really did get under way, what would the central banks do about it? Still more QE? Negative nominal interest rates? The printing up of a new kind of date-stamped currency that expires worthless unless promptly spent? Dollar bills dropped from helicopters or posted directly to the people, bypassing the banks? In any case, not nothing.

"It is time to call owning gold what it is: an act of faith," writes our friend Jason Zweig in the past weekend's *Wall Street Journal*. "As the Epistle to the Hebrews defined it forevermore, 'Faith is the substance of things hoped for, the evidence of things not seen.' Own gold if you feel you must, but admit honestly that you are relying on hope and imagination."

Hope and imagination are states of temperament in evidence on both sides of the monetary debate (therefore on both sides of the gold question). That $10 bill in your wallet, the one that—for the moment—bears the likeness of the author of the Coinage Act of 1792, which established the nation's gold and silver monetary standard—does it not owe its value to faith? There's little behind it except the judgment of the central bankers who sometimes turn up on CNBC to say that, depending on the data, they will or won't vote to attempt to lift the funds rate in September or December or, then again, maybe some time in 2017.

Gold pays no interest; that is the property of money. Biotech stocks, most of them, pay no dividends, though that is not the property of common equity. Biotech investors own options on events that, though unlikely to materialize, would pay off handsomely if they did. So, too, we submit, with gold stocks, and the more so the further they fall. Mining shares are leveraged claims on gold bullion. Gold bullion is an investment in monetary and financial disorder. We say that disorder is manifest in exchange rates and in the distortion of interest rates and asset values. That is the minority view. Maybe it will gain adherents. It deserves to.

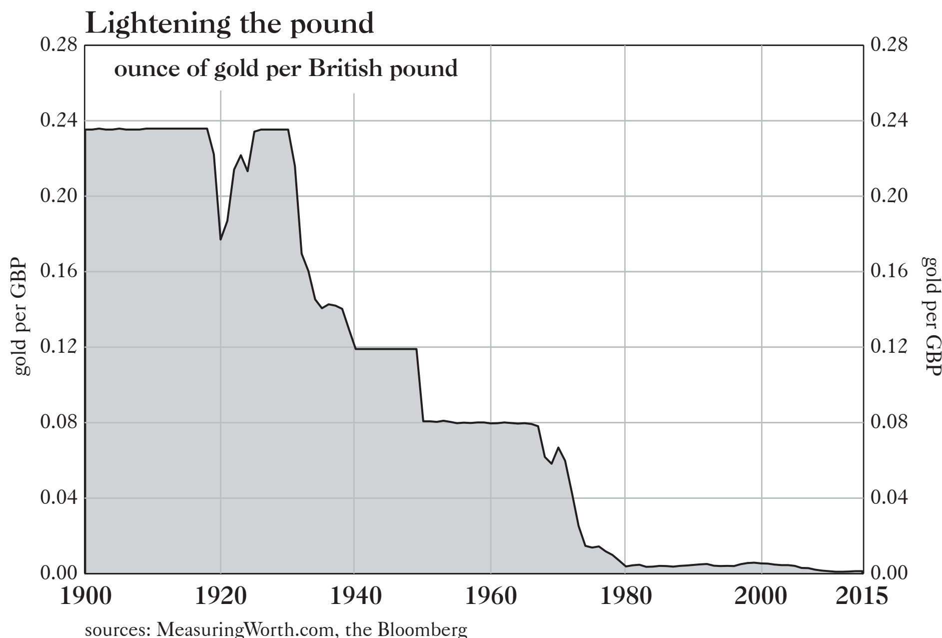
Paying no interest, earning no profits, gold tends to bring out the faux forecaster in its friends and foes alike. "It's just a price," remarks a long-suffering bull we know—"and we don't like it." Your editor cringes to re-read the 2012 essay he wrote to preview the monetary policy regime of Janet Yellen (*Grant's* Nov. 16, 2012). "Gold bulls should light a candle on her birthday, Aug. 13, and pray that she rises to lead the Fed when it's time for the chairman to go. If Bernanke is good for, let us say, $3,000 an ounce in the bullion price, Yellen is a force for $4,000." Maybe *Grant's* was the hubristic force for $1,100 an ounce.

There's a saying, "gold drives men mad." It certainly loosens their tongues, especially when the price trend is, from the speaker's point of view, propitious. Back on Dec. 13, 1997, with gold quoted at $282.85, the *Financial Times* actually wrote its obituary. "The Death of Gold,"

was the headline. The price was less than $5 higher in 1999 when *The New York Times* weighed in with a piece of commentary under the headline, "Who Needs Gold When We Have Greenspan?" (The world will become ever more dollarized, the argument went, because the Greenspan Fed had at long last solved the mystery of money.) People get carried away at the upside extremes, too. A *Wall Street Journal* columnist wrote a bullish story on the gold-mining stocks on Sept. 19, 2011, just two weeks after gold put in its—for now—high price of $1,900. His name was Jason Zweig.

After Monday's wipeout, Bianco Research noticed that, according to new Commitments of Traders data, money managers in the aggregate hold a net short position in gold futures for the first time since the start of reporting of disaggregated CoT figures in mid-2006. To us it seems as if most everyone were on one side of the monetary boat—the Ph.D. standard side.

•



Posterity will smile

(June 26, 2015) On June 16, the editor of *Grant's* delivered a talk under the auspices of Russell Napier's Library of Mistakes in Edinburgh, Scotland. The text of his remarks, including some things that he wishes he had thought to say, follows:

It isn't my mistakes that bring us together this evening—not enough time for that. My topic is rather our collective mistakes. The question I mean to address is how will posterity judge them. Which mistakes—financial ones, that is—will our children's children identify as our most gratuitous?

This will take some soothsaying. It's hard enough to separate good judgment from bad in the moment of decision (obviously, if mistakes were clearly labeled as such, people would make fewer of them). It is that much more difficult to attempt to judge how posterity will rank-order our poor choices.

In preview, I am going to put discretionary monetary rule by former college professors at the head of the list of errors over which our descendants will roll their eyes. Deflation-phobia and inflation-philia come next, followed by a general willful ignorance of financial history. Fallen mortals, we *will* err. Reading widely in the words on deposit here at the Library of Mistakes, we could at least err more imaginatively.

You know posterity. You know because we *are* posterity. We tsk tsk at the avoidable errors of the past, or at least at those errors that we judge to have been avoidable. We shake our heads over tulip mania, the South Sea Bubble, the depression of the 1930s, the inflation of the 1970s and the dot-com bubble of the millennium. How could those people—which is to say, our predecessors on this planet in this business—have been so purblind? I propose that futurity will judge our long-running post-2007 experiment in zero-percent interest rates and digital money printing to be just as incomprehensible.

Britain's decision to return to a kind of gold standard in 1925 at the prewar rate of exchange will serve as the historical touchstone of my remarks. John Maynard Keynes argued against it. Winston Churchill contended for it. History—lining up with Keynes and with a very different kind of critic, the great French economist Jacques Rueff—judges the choice to have been disastrous. Whatever your view, the 1925 monetary tussle changed history. It sparked the ideas we live by, which ideas I happen to wish we could live without.

Which ideas might these be? No. 1, that money is an instrument of public policy and not—as wiser heads than ours had long believed—a unit of measurement. No. 2, that interest rates should be administered by the mandarins, not discovered by the market. No. 3, that the consequences of major financial decisions should devolve to the state, not to the individual.

Keynes lost the political contest—Britain did adopt the gold exchange standard in 1925—but won the historical point. Today's central bankers treat money like water. They turn the faucet on, and they turn the faucet off—or they *could* turn the faucet off. Whether or not Richard Nixon ever said, "We are all Keynesians now," that phrase aptly describes 21st central banking doctrine. "No standard is the best of all standards" is the lesson that mainstream opinion leaders have taken away from the events of 1925.

Keynes produced a characteristically brilliant attack on the plan to return to gold. "The Economic Consequences of Mr. Churchill," published in 1925, was a comprehensive debunking of post-war orthodoxy. "Sound finance," Keynes ironically called it. In fact, the newfangled monetary arrangements of the 1920s were deeply flawed. With the passing generations, they have steadily become more flawed. Ninety years later, exchange rates wildly oscil-

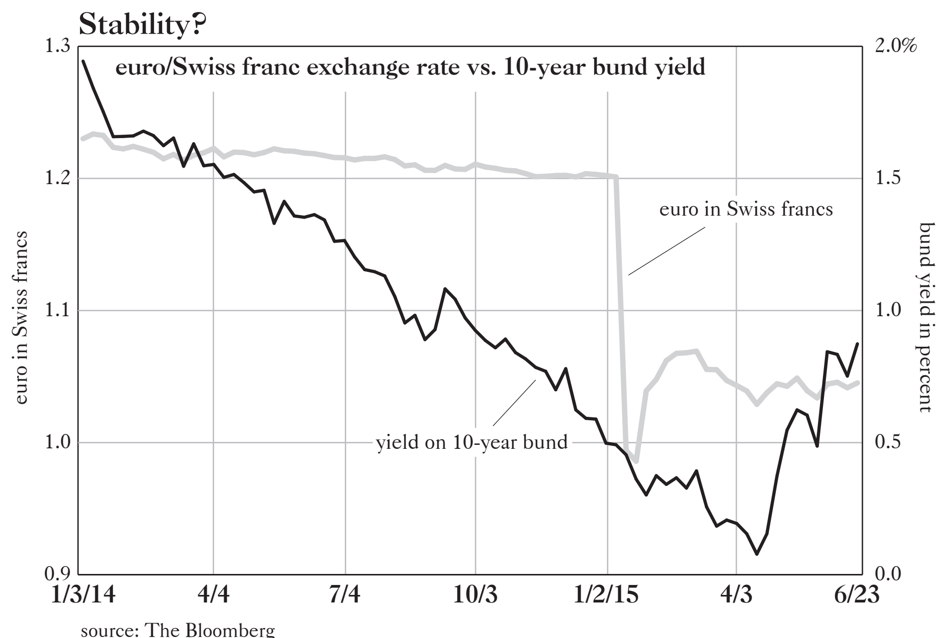
late while money-market interest rates lie lifeless at the so-called zero bound. Improvisation is the monetary watchword—"learning by doing," as Ben Bernanke put it.

Up until the shooting started in August 1914, the pound was a unit of measurement—a weight, as its name implies. It was defined as 113 grains of gold. You could exchange your bank notes for gold, and your gold for bank notes on demand—an ounce was worth four pounds, four shillings and 11 and three-quarter pence, to be exact. Because people could make the exchange, and because gold could freely enter and leave the country, the gold value of the pound was evidently inviolable.

The gold standard stopped when the shooting started. Under wartime strictures, no bullion was permitted to leave the country. The right of conversion from metal to paper and back again was suspended. No matter its definition in law, the pound became a depreciating piece of paper. From the start of 1914 to the close of 1918, British prices virtually doubled. By 1925, debt service had become the biggest line item in the British government's budget.

It spoke well of the prewar gold standard that, come the peace, most desired to return to it. The devil was in the details. The City of London, by and large, supported resumption of a new kind of gold standard at the prewar rate of exchange. Captains of heavy industry, by and large, opposed it. A fixed standard of value would be no great blessing at an overvalued rate of exchange—and in a society that had made a political choice that nominal wages should never fall. Then, too, the Bank of England's discount rate would have to be pitched high enough to attract and hold gold, whatever the state of domestic business activity.

A parliamentary currency committee, reporting in 1924, disputed that British prices were out of line with those of the rest of the world. An adjustment of 1% to 1 ½% would do the trick. "[A] courageous policy in currency matters surmounts apparently formidable obstacles with surprising ease. . . ," the committeemen concluded. Yes, they allowed, some temporary rise in interest rates might be necessary. "We are satisfied, however," they went on, "that the assimilation of British currency to the gold currencies of the world is so necessary for the prosperity of British trade that any temporary disadvantage, if such arise, from the measures necessary to maintain parity will be many times outweighed."



In response to sneers from the opposition benches that the gold standard would "shackle" British prices to America's gold dollar, Churchill shot back, "I will tell you what it will shackle us to. It will shackle us to reality."

The reality of a market economy is that prices and wages must be flexible in both directions. They can't stand still as long as tastes, technology and competition are changing. The partisans of inflation, then and now, oppose falling prices. I am going to say that the natural tendency of prices in a productive market economy is downward. They fall as the techniques of production improve. One might—I would—call this "progress." Today's central bankers rather call it "deflation." Inflation-philia and deflation-phobia are two sides of the same intellectual coin.

Still, when a price becomes distorted, something has to give. What might that something be? Nowadays, we lay the burden of adjustment on interest rates and exchange rates—on the value of money, or the cost of money, rather than on an underlying distortion in the marketplace. Better that interest rates should fall than, just for example, house prices should fall. Better QE and ZIRP than the sudden, full consequences of the preceding levitation in residential real estate. So holds the consensus of Keynesian political opinion.

There was a constituency for these ideas even before Keynes made them popular. "I have sense enough to realize that it may be in the interests of the country to go back to the gold standard," John Baker, a Laborite son of a bricklayer, said in parliamentary debate, "but don't tell me it is in the interests of the men who will be thrown out of work."

Baker had nothing against the gold standard per se—the problem lay in the exchange rate. Neither did Philip Snowden, a former chancellor under the Labor Prime Minister Ramsay MacDonald, object to the gold standard in principle. He protested against the precipitous rush to restore it. To judge by the tone of discussion, the gold pound commanded widespread support. Keynes himself would sometimes lightly tip his hat to it.

He tipped it more energetically to the emerging idea of managed currencies. His "Economic Consequences of Mr. Churchill" belittled the price mechanism and deployed the rhetoric of social justice in contending against wage reductions. It scorned "conventional finance" and

"so-called sound policy," thus anticipating—no doubt helping to bring to fruition—the generations' long redefinition of the term "sound." To Keynes, the free market was a machine, a "Juggernaut." Heartless and headless, it needed helping hands—his, for instance.

"The gold standard," he wrote, "with its dependence on pure chance, its faith in 'automatic adjustments,' and its general regardlessness of social detail, is an essential emblem and idol of those who sit in the top tier of the machine." Britain was running an unwise risk "if we continue to apply the principles of an Economics which was worked out on the hypotheses of laissez-faire and free competition in a society which is rapidly abandoning these hypotheses." In other words, the price mechanism would certainly fail to function if it were not allowed to function—you could hardly argue with *that* Keynesian doctrine.

Keynes was in touch with his times, certainly. Even the self-described proponents of the gold standard turned away from the classical prewar edition of that elegant monetary system. They wanted the respectability without the rigor (putting aside, for a moment, the all-important matter of the exchange rate). What they rather embraced was the gimmicky gold exchange standard. It was a yardstick made of rubber.

A Bloomsbury wit had said that a proper cake was one that you could have *and* eat. Here was the essence of the gold exchange standard—in fact, it remains today, the essence of our non-standard, what we at *Grant's* call the Ph.D. standard after the one-time tenured economics faculty who guide our monetary destiny. Before 1914, gold-standard countries settled their international accounts in gold or in currencies immediately convertible into gold. Under the gold exchange standard, sterling (and dollars, too) did double duty as official reserves. They themselves became a kind of paper gold. Britain could—and did—allow sterling liabilities to pile up offshore, secure in the (errant) conviction that its creditors would never demand bullion in exchange for its proliferating pounds.

The broad effect of the gold exchange standard "will be not only to allow for an unlimited credit expansion without inflation but also to aim at price stabilization and, incidentally, at wage stabilization. . . ." So Robert Boothby, a Tory MP, promised the House of Commons in 1925. "What I want to emphasize," Boothby went on, "is that we have really passed beyond the stage where one can recommend that there should be no control of economic forces, and that is why I hope we are not going back to a purely automatic gold standard."

"Unlimited credit expansion without inflation"—does that not have a modern ring to it? Unfortunately for our 21st century prospects, the Boothby-warranted monetary system collapsed in a heap in 1931. When push came to shove, Britain's creditors did demand gold, which the Bank of England declined to remit.

If our financial descendants are as busy as we are, they will likely lump the manifold errors of the post-crisis period under the broad heading of offenses against common sense. They will be thunderstruck by the things we believe.

I have in mind one particular example of gullibility. We give every sign—I mean, we collectively—of accepting the notion that price control is a viable idea. You may be surprised, as price control is demonstrably non-viable. It has never worked, and no major central bank explicitly sails under its colors. Still, by fixing some interest rates, obliterating others, and nudging still others, the monetary thimble riggers have instituted an effective regime of financial price control. Interest rates are prices, after all.

The abuse of the price mechanism is the principal narrative thread of 21st-century central banking. The authorities profess to believe that they can micro-manage the "price level." I doubt that the price level can be accurately computed, let alone managed to within a few dozen basis points of the central bankers' chosen

Subscribe for one year . . . **Get 30 years for free**

GRANT'S
INTEREST RATE OBSERVER
Leave your worries in the inbox

Every *Grant's* subscriber gets unlimited digital browsing privileges in the four-million word *Grant's* archive. That's three full decades worth of essays, analyses, prophecies and cartoons at no additional cost. Think of it as a top-flight graduate program in finance—a program in which you, Mr. or Ms. Star Student, are on a full scholarship.

target. As to the calculation, I refer you to Oskar Morgenstern's critique of the pretenses of statistical precision, "On the Accuracy of Economic Observations," a book more than half a century young. Without knowing, I somehow know that Mario Draghi was not thinking of the skeptical Morgenstern when, last summer at Jackson Hole, Wyo., he invoked the message of the "five-year, five-year" forward inflation rate—meaning the inflation rate projected by futures markets for the half decade beginning in five years' time—as a pretext to implement QE. Mind you, Draghi was drawing inferences about the rate of inflation beginning in the year 2019. Believing that, what could the president of the European Central Bank not believe?

The Federal Reserve's self-selected mission is to cause the price level, as defined, to rise by five-fold over the course of a healthy lifetime. This is the honest meaning of a 2% inflation target. Oddly, the central bankers call it "price stability."

It appears that Churchill did, indeed, underestimate the overvaluation of the pound in 1925. Still, in arguing for what turned out to be the wrong policy, the then chancellor of the exchequer said something that our data-driven Federal Reserve would be well advised to ponder: "Those who found clear-cut mathematical calculations on these index figures are likely to strain the figures further than they are warranted and to draw the wrong conclusions."

The failure of the half-baked gold exchange standard discredited the true-blue gold standard. The failure of the successor, the post-World War II monetary system known as Bretton Woods, discredited the very idea that currency values should be fixed or anchored. Britain's 1992 departure from the European Exchange Rate Mechanism was another nail in the coffin of fixedness.

Today, we stand at the gates of Keynes's and Boothby's monetary heaven. Exchange rates bob, weave and lurch—in a few minutes of frenzied trading on January 15, the Swiss franc leapt by 41% against the euro. Just in the past few weeks, German bund yields climbed by 1% from not many basis points above zero. The move wiped out more than a dozen years of coupon income. The fact is that today's central bankers, in league with yield-starved investors, have engineered a comprehensive mispricing of credit not seven years after the previous such episode of mispricing. Bloomberg, the other day, quoted analysts from Bank of America as saying that, "We believe we are seeing the slow unraveling of the fixed income markets."

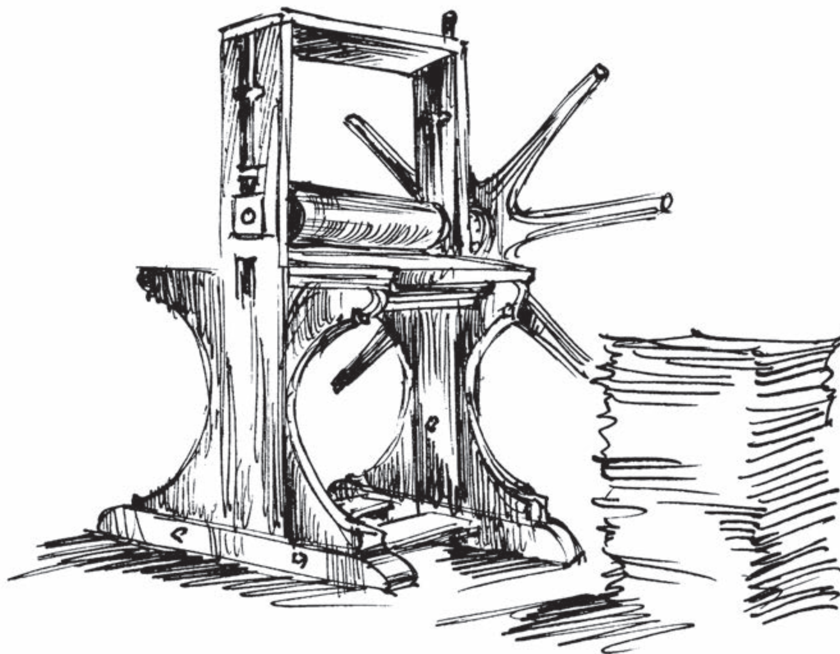
Here in Adam Smith's hometown, I have presumed a little on your affinity for the invisible hand. If you are not so keen as I on price discovery and the free market, I hope at least that you will give some thought to the risks inherent in price administration in a controlled market.

Finally, I hope that we can change our ways before posterity can shake its head at the memory of our mistakes.

•

Made for sharing: *Grant's* reprints.

Your favorite* Grant's *articles
—prepared to order



Have you found a ***Grant's*** article to be of special interest? Share a customized reprint with friends and clients. Articles are quickly reformatted and forwarded to you to reprint.

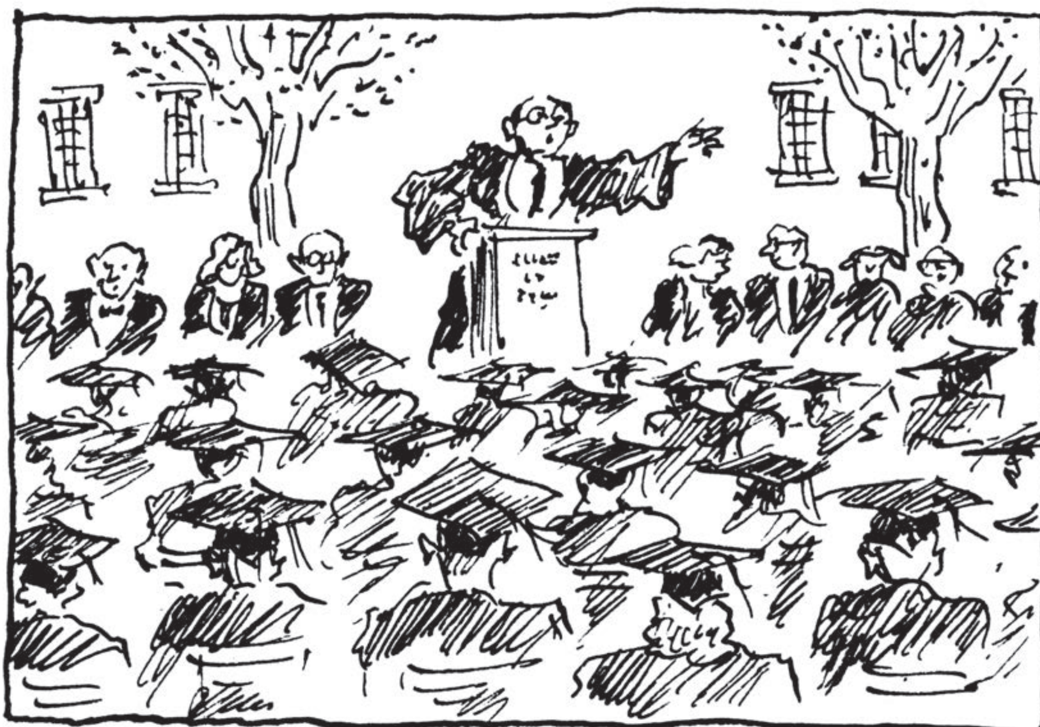
Call 212-809-7994 for details.

Attention, Professors!

Do you teach a class in economics or finance?

Can you imagine a *better* teaching aid than *Grant's*?

Please call to find out how you can put ***Grant's*** articles into the hands (and, if possible, into the heads) of tomorrow's financial leaders.



"And, I urge you, America's future leaders—read Grant's."

Call 212-809-7994 during NY business hours and ask about our phenomenally reduced bulk rate for classroom use.

Vacation delectation

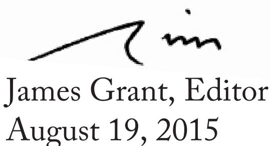
To the readers, and potential readers, of *Grant's*:

This anthology of recent articles, our summertime e-issue, is for you. Please pass it along, with our compliments, to any and all prospective members of the greater *Grant's* family.

Not yet a subscriber? Make yourself the gift of a year's worth of *Grant's* and get two issues added on to your subscription. That's a $230 value.

We resume regular publication with the issue dated Sept. 4 (don't miss it!).

Sincerely yours,



James Grant, Editor
August 19, 2015

GRANT'S
INTEREST RATE OBSERVER®

Vol. 33 Summer Break

Two Wall Street, New York, New York 10005 • www.grantspub.com

AUGUST 19, 2014

Not such a lock

(February 6, 2015) A wave of identity theft and computer-borne financial fraud has hoisted LifeLock—LOCK on the New York Stock Exchange—into the elite ranks of American growth stocks. "Elite" is no part of the LifeLock corporate story, *Grant's* is about to contend. On the company whose CEO famously paraded his own Social Security number in front of the TV cameras just to dare bad actors to steal it (which the taunted thieves actually proceeded to do), this publication is bearish.

Anxiety is LifeLock's stock in trade. If North Korea (let us say) can hack Sony Pictures Entertainment, and if JP Morgan Chase, Home Depot and Target are likewise vulnerable to digital intruders, which ordinary citizen is safe? Some 3.5 million Americans, deciding that they, at least, are unsafe, have signed on. In the 12 months through Sept. 30, LifeLock's revenues jumped by 30% from the year- earlier period. From 2007 through 2013, compound annual growth in the LifeLock top line amounted to no less than 64%; results for the final quarter and full-year 2014 are due on Feb. 10.

Between five and 15 million Americans are annually hacked, according to estimates by Forrester Research and the Department of Justice. "Let's assume," Richard Davis Jr., analyst with Canaccord Genuity, muses with colleague Evan Lorenz, "the only people who have any interest in this product is someone who actually had their identity hacked. So, that's seven million people per year. With LifeLock's churn, which is about 18%, they have to land about 1.2 million of that seven million, so they have to get 17% of those people in that narrowly defined universe of people who had their identities hacked. If that's all they won, a 17% win rate is not that bad. It's not like they need 50% to 60%."

The argument appears to have carried the day with all but one of the nine analysts who follow the company. The shares are valued at 28.9 times trailing net income and 22.7 times the 2015 estimate. Cash per share works out to $2.55; the balance sheet is debt-free. Not since going public in October 2012 has management produced a disappointing quarter. Boldface names—Goldman Sachs, Bessemer Venture Partners, Kleiner Perkins Caufield & Byers—furnished venture capital. Tom Ridge, former head of the Department of Homeland Security, sits on the board of directors.

What, exactly, does LifeLock deliver? Less than the "comprehensive identity theft protection" that it claims. The standard LifeLock protection plan, which sells for $9.99 a month, buys you notification if a credit card account (or mortgage or mobile phone application) is opened in your name. It promises assistance in canceling lost or stolen credit cards. It guards against attempts to tamper with your address. It scans Web sites for signs that someone is filching your vital data, and it blocks pre-approved credit card offers and offers a $1 million service guarantee in case of fraud. For the customer who wants to know if a registered sex offender has moved into his neighborhood or who demands instant notification of major corporate data breaches, higher and costlier levels of service are available. Except for a small enterprise division that verifies customer bona fides for corporate clients, consumer protection is LifeLock's beating heart.

You might suppose that the anti-identity theft industry is thriving. In fact, annual average top-line growth over the past five years amounted to just 0.5%, according to Sarah Kahn, analyst at IBISWorld. Revenue at the only other public company focused on identity-theft protection—Intersections Inc. (INTX on the Nasdaq)—slipped to $262 million in the 12 months ended Sept. 30, 2014, from $373 million in calendar 2011. Intersections markets through banks, where it has collided with the Consumer Financial Protection Bureau. LifeLock has had no such difficulty issuing ads to the hack-wary public.

Many a business in the Internet age has foundered in failing to compete with services that someone, somewhere can deliver for free. Perhaps such a fateful encounter awaits LifeLock. "Consumers can request their credit reports once

"Fiat, boys! I found fiat!"

SB2015

Subscribe today and save! Fax or mail the form below, go to www.grantspub.com/sb2015 or call 212-809-7994.

❑ **Yes, I want to subscribe.**
Enclosed is my payment (either check or credit card).
(I understand I may cancel at any time for a prorated refund on the remainder of my subscription.)
Order by the deadline and we will add two free issues **—an additional $230 value—**onto the end of your subscription.

Offer good until December 15, 2015
Order online: Offer code:SB2015

Questions? Call 212-809-7994.
Fax your order: 212-809-8492

❑ 1 year (~~24 issues~~) **26 ISSUES for $1,175 U.S./$1,215 Foreign**
❑ 2 years (~~48 issues~~) **50 ISSUES for $2,125 U.S./$2,165 Foreign**
❑ Check enclosed*
*Payment to be made in U.S. funds drawn upon a U.S. bank made out to Grant's.

______________________ Exp.________
Credit card number

Signature______________________

CV number ________ (3-digit code on back of VISA/MC/Disover; 4-digit code on front of AMEX)

Name ______________________
Company ______________________
Address ______________________
____
____
____
Daytime Phone ______________________
E-mail______________________