A “thrift” for our time

Countless man-years have been devoted to the search for the perfect investment. It has almost become a banal occupation. However, the hunt for the least perfect investment has attracted relatively little interest. Where is this grail-in-reverse? What would it look like if one came across it?

The worst investment would be badly secured and illiquid, of course. It would offer a yield—but, ultimately, would fail to pay it. It would look substantial but would furnish no substance.

It would be presumptuous to hold up the one-year 9 1/2% debentures or the two-year 10 1/2% debentures of American Continental Corp. as the worst securities available. That is up to the financial jury, which is out. At the least, however, the bonds are instructive, for they lead the student of markets to their issuer, American Continental, and then to the issuer’s thrift subsidiary, Lincoln Savings & Loan. These are emblematic institutions—companies for our debt-laden, shot-taking time.

You probably have read about Lincoln, a $4.7 billion California thrift that has been fighting with the Federal Home Loan Bank Board. Lincoln is said to have undergone the longest audit in the Board’s history, and matters raised in the FHLLB examination report have prompted an order of investigation by the SEC. Charles H. Keating Jr., chairman of American Continental, the holding company, is noted for financial innovation, strong views and survivability. At Lincoln, he chose to make money with credit risk rather than with interest-rate risk, and he transformed a conventional thrift into a space age model. In high places, he counts friends and enemies alike. The National Thrift News has disclosed that no fewer than five U.S. Senators intervened with federal regulators last spring on behalf of Lincoln, “pressing for more liberal appraisals on the thrift’s real estate investments.” In Phoenix, according to a local businessman, Keating has shown “incredible ability to convert assets into cash.” He is going to need it (there’s talk of a sale of Lincoln itself to a group led by the thrift’s newly resigned chairman, but so far no action).

Lincoln is a thrift only in name. Instead of conventional home mortgages, it has stocked up on commercial real estate, real-estate loans and junk bonds. These assets it finances with federally insured deposits, thereby sharing its risk (but not its profits or the handsome salaries of its officers or the handy privileges of its insiders) with the insurance-assessment-paying members of the thrift industry. Ultimately, if the federal deposit insurance system keeps going downhill, Lincoln will share its risk with the taxpayers, who have not been consulted on the composition of its investment portfolio.

The margin for error is tight. For instance, the real-estate assets of the holding company totaled $821 million at year-end. Of this total, “land acquired for development” was $591 million, “land held for resale” was $170 million and real-estate acquired through foreclosure was $78 million. Allowance for possible losses was $19 million. It is a number that, although double the 1986 reserve, suggests an optimistic reading of the Southwest market (the company’s real-estate activities are concentrated in the non-boom states of Arizona, Colorado, Georgia and Texas). To put the $821 million real-estate portfolio in perspective, consolidated year-end equity was $137 million. The junk-bond portfolio is a little smaller than the land portfolio: $622 million at year-end, up from $561 million in 1986, but a large multiple of net worth.

One consequence of the company’s emphasis on real-estate investment, or speculation, is that its selling, general and administrative expenses handily exceed its net interest income. Unlike the typical thrift, its income is dependent on the sale of securities and real estate, i.e., on sources of revenue usually deemed irregular, or nonrecurring. American Continental is a kind of real-estate-development and junk-bond enterprise, subsidized, in good measure, by the Federal Savings & Loan Insurance Corp., which is broke.

Since 1984, the year American Continental acquired Lincoln, the holding company’s leverage has risen and its return on assets has fallen. Ratio of equity...
to assets over the past several years has trended this way: 6.36%, 1984; 3.47%, 1985; 2.88%, 1986; and 2.75%, 1987. In 1984, return on average assets was 1.02%; in 1987, it was 0.4%. With all that leverage, you might have expected big gains in return on equity, but they didn’t happen. ROE was 14.6% last year, a shade lower than in 1984.

With the approval of the Bank Board, American Continental has begun to offer its debentures—the subordinated one- and two-year securities nominated above for consideration as worst investments—in Lincoln’s 29 branch offices in Southern California. A five-year bond is also available at 12%. The bonds are meant to be held to maturity or to the holder’s death, whichever comes first. The selling literature serves fair warning on the lack of liquidity: “These bonds are not traded in the secondary market, but they can be transferred to another individual. It is the responsibility of the debenture holder to determine a suitable price and locate the buyer.” That may or may not be easy, as the field of potential investors, possibly, is limited to people who don’t read, or who can’t understand, the American Continental prospectus.

The document is a pip, describing a perfect miniature of new-era finance. For instance: “Virtually all loans made since the acquisition of Lincoln Savings require ‘balloon’ payments of principal at various points up to, and including, final maturity of the loan.... The risk of loss on all loans depends upon the accuracy of appraisals. However, the risk of loss from an inadequate appraisal for any particular loan is greater with larger loans....” And so forth. The document cautions that debenture holders have no claim against American Continental’s subsidiaries, notably the thrift subsidiary. In point of fact, as an interested reader points out, the holding company, ex-Lincoln, suffers a deep negative net worth. How, then, can the bondholders expect to get paid? Absent dividends from subsidiaries (the payment of which depends on approval from Lincoln’s friends at the Bank Board), the company means to borrow the money—or tap the subs for miscellaneous advances and “tax sharing agreements.”

Some months back, Roderick MacIver & Co., Basking Ridge, N.J., issued a blistering report on American Continental, citing, among other unflattering things, a series of property transactions with insiders. “Over the last three years,” said MacIver, “the company has sold $92 million of its properties to entities affiliated with insiders. In one instance, the company provided $3 million in secondary financing to the purchasers, who put none of their own money down.”

The 1988 proxy statement disclosed the purchase of 417,000 shares of American Continental stock from the insiders, including 117,000 shares from Keating himself on November 5 at 6. It was a timely accommodation for Keating, inasmuch as the total volume of American Continental traded on NASDAQ that day was just 16,300 shares. It can be imagined that a block of 117,000 shares would have weighed heavily in the marketplace just three weeks after the crash.

The public should be reminded that no such instant liquidity is available to the holders of the American Continental debentures. You must wait out the maturity date or die. The prospectus contains the details. Read it carefully before you invest or send money.
Subscribe to Grant’s

and get TWO FREE ISSUES added on to your subscription...

AND a signed copy of Jim Grant’s latest book:*  

Don’t wait. Subscribe NOW.

Take us up on this offer and you’ll receive 26 hard-copy issues instead of 24 (a $230 value), complimentary online access to the current issue, the issue archive, AND Jim Grant’s latest book, “The Forgotten Depression: 1921 The Crash That Cured Itself.”

Go to www.grantspub.com/subscribe. Use Offer Code: GADG

☐ Yes, I want to subscribe. Enclosed is my payment (either check or credit card).

Subscribe now and we’ll add two free issues onto your subscription. That’s 26 issues instead of 24—a $230 value. We’ll also send you a signed copy of Jim Grant’s latest book, “The Forgotten Depression, 1921: The Crash That Cured Itself.”

*New subscribers only, as supplies last

☐ 1 year (24 issues) 26 ISSUES for $1,175
☐ 2 years (48 issues) 50 ISSUES for $2,125
Group rates available upon request.
☐ 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/Discover;
4-digit code on front of AMEX)

Name ____________________________________________
Company __________________________________________
Address __________________________________________
_________________________________________________
_________________________________________________
_________________________________________________

Daytime Phone (required)

E-mail ____________________________________________

*New subscribers only, as supplies last

THREE WALL STREET • NEW YORK, NEW YORK 10005-2201 • P: 212-809-7994 • F: 212-809-8492 • WWW.GRANTSPUB.COM

GO TO WWW.GRANTSPUB.COM/Subscribe. USE OFFER CODE: GADG