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Wire-pullers of the twenty-first century

Markets are just as efficient as the people who operate in them. They are just as cool, calm and collected as the humans who will buy high and will sell low. Still, they are devilishly hard to beat. You begin to suspect that Mr. Market has relinquished control of financial outcomes to certain unknown powers. What they might be is the subject of the following speculation.

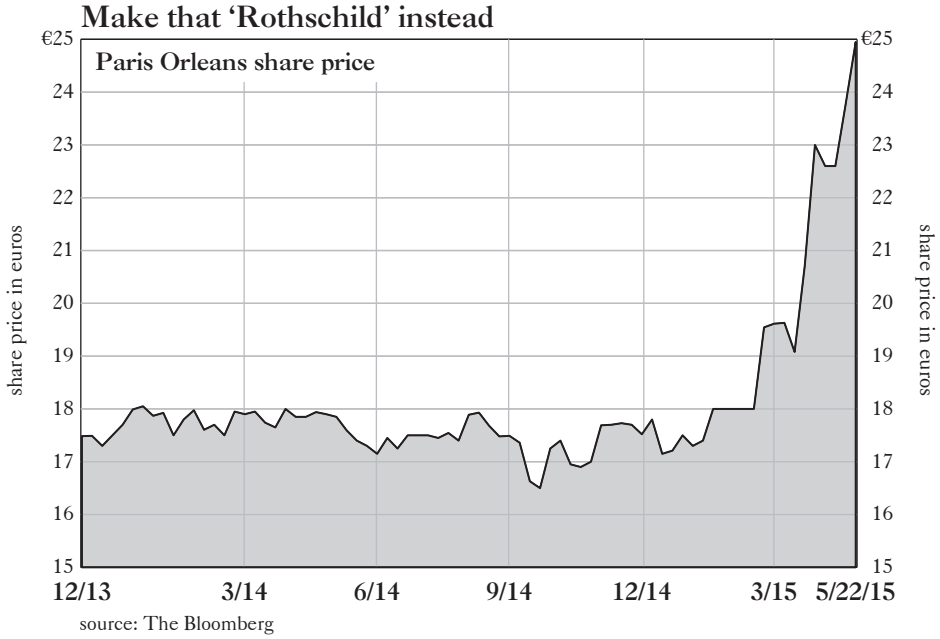
In the case of the 27% upside lurch in the shares of Paris Orleans SA (PAOR in Paris), the holding company of the French and English branches of the storied house of Rothschild, we suspect the intercession of the gods. Though the company was not profitable and the shares were not cheap, the issue of *Grant's* dated Dec. 13, 2013 ("European antique show"), identified reasons to expect improvement—which improvement in operations and profitability duly materialized. Still, the Paris Orleans share price remained in a kind of trance until an April 8 press release announcing neither a suitor in the wings (the company is controlled by the Rothschilds, as is well known), nor a tangible new catalyst for higher earnings. The news was a change in name. The firm would no longer be called Paris Orleans. It would be rebranded Rothschild & Co. What's in a name? In the case of the name "Rothschild," some €375 million in market cap.

The power of the central bankers, though earthbound, is almost as potent and mysterious as that of the fun-loving gods. In general, today's asset prices are very high. They are high, in part, because interest rates are low and because the terms and conditions of lending—for the right kind of corporate suit-wearing loan applicant—are unusually lenient. Thus, so-called covenant-lite loans, the kind featuring indulgent terms and conditions, have amounted to 67% of $177.8 billion of syndicated loans issued to leveraged businesses so far in 2015.

For these and other causes, share prices of the so-called platform companies have zoomed into orbit. Endo International PLC (ENDP on the Nasdaq), a Pennsylvania company for corporate purposes though an Irish company for tax purposes, is a pharmaceutical-industry example of the type—a bearish analysis of Endo appeared in the issue of *Grant's* dated last July 25.

Like Valeant Pharmaceuticals International, famous stalker of Allergan, Endo is a doer of deals. It borrows money with which to make acquisitions. It is a fact—established in academic studies beginning as long ago as the turn of the 20th century—that M&A is generally more profitable for the investment bankers than it is for the principals. "Today's credit-driven market seems to have forgotten this fact," colleague Evan Lorenz observes, "and rewards most buyers with higher stock prices."

"Think of what the pharma companies are doing," James H. Litinsky, eponym of JHL Capital Group LLC, Chicago, tells Lorenz. "They are using free money to buy assets, then move them offshore, not pay taxes and raise prices. So Valeant, if you look closely at what they do, they just raise prices. They



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lose volume. They cut R&D and jobs and don't pay taxes. The Fed is handing out free money. Liberals complain and want to raise taxes. Actually, the Fed is handing out free money to people moving jobs overseas and not paying taxes and raising prices on people. No one understands it. That is the externality of the insanity of Fed policy."

Back to Endo, which on May 18 said that it was prepared to pay $8.05 billion to acquire Par Pharmaceutical Holdings, a specialist in generic medicines. The price is four times greater than the one that TPG Capital paid for Par as recently as 2012, and represents a multiple of 16.5 times Par's trailing EBITDA.

You won't raise many Wall Street eyebrows with the mention of a mid-teens multiple of earnings before interest, taxes, depreciation and amortization. The average pharma and biotech acquisition these days is priced at almost 30 times EBITDA, according to Bloomberg. What rather could incite some low whistles of disbelief is the set of managerial assumptions on which the promoters project the hope that the Par acquisition will be quickly accretive to Endo's earnings.

For instance, Endo says it expects to cut a combined $175 million from Par's operating and tax outlays, principally in R&D and selling, general and administrative expenses. Just how deep the knife must cut is evident in the fact that, in 2014, Par spent $119.1 million on R&D and $181.1 million on SG&A.

Legal expense is also considerable. As a filer of generic drug applications, Par is constantly doing patent-related battle with branded drug companies. It spent $90.1 million in litigation-related expenses last year. A gimlet-eyed reader observes that no such cost was acknowledged in Endo's public presentation of Par's adjusted EBITDA. Even so, Endo expects Par to boost its revenues at a double-digit rate for the "near to mid-term," just as TPG management was able to achieve.

If the in-house Endo crystal ball is in working order, the Par acquisition will be accretive to Endo's earnings within 12 months of the closing dinner. What might deliver this boost to net income? Not a tax gimmick. Par is a "full U.S. taxpayer," as Endo sorrowfully acknowledges. Nor, seemingly, cost cuts, as they will be offset by integration expenses. Credit, rather, the low cost of financing.

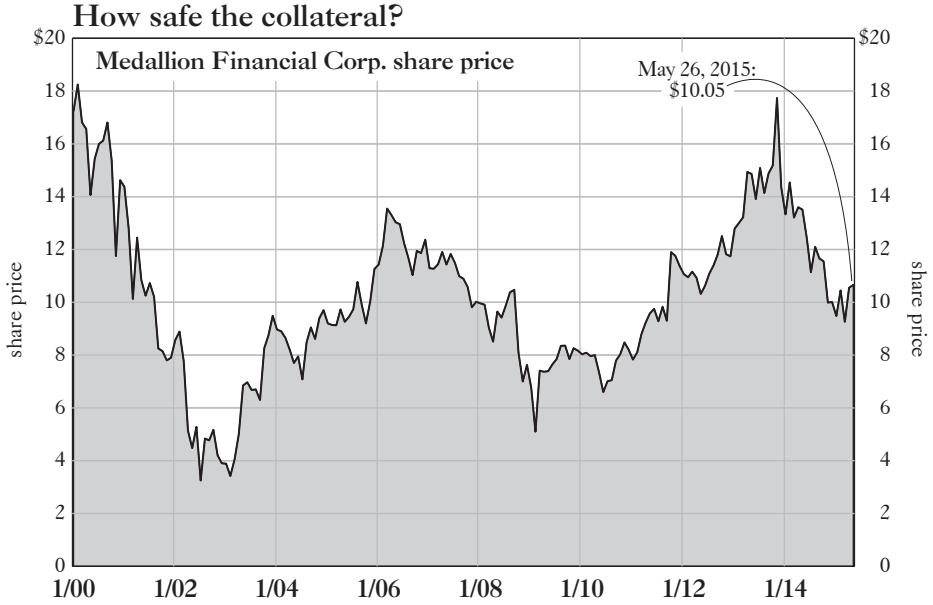
"Single-B-plus-rated Endo will be borrowing, net, upwards of $4.9 billion to snag Par," Lorenz points out. "It will likely pay not much more than 5% for the privilege. The low cost of borrowing has to be a major—if not the major—driver of accretion within the first year."

On top of everything else, as Litinsky mentions, not many drugs have a commercial shelf life as long as aspirin's. "Pharma is like technology," Litinsky observes. "So, it is hard to predict what will happen in 10 years, but it is likely that any of these drugs, even if they are generics with no competition, will eventually face obsolescence." If R&D is the seed corn of tomorrow's revenues, the accountant's knife now poised over that critical expense line could prove costlier than the promoters are willing to acknowledge.

A chap named John Fullerton, writing in England in 1848, posited that at a rate of interest as low as 2%, "capital habitually emigrates, or. . . is wasted on foolish speculations, which never yield any adequate returns." It's as if the Victorian had a presentiment about the spate of 2015 share buybacks (on pace to set a record) and the burst of borrowing to effect them.

"In the restaurant business," writes John Hamburger in the May 15 edi-

How safe the collateral?



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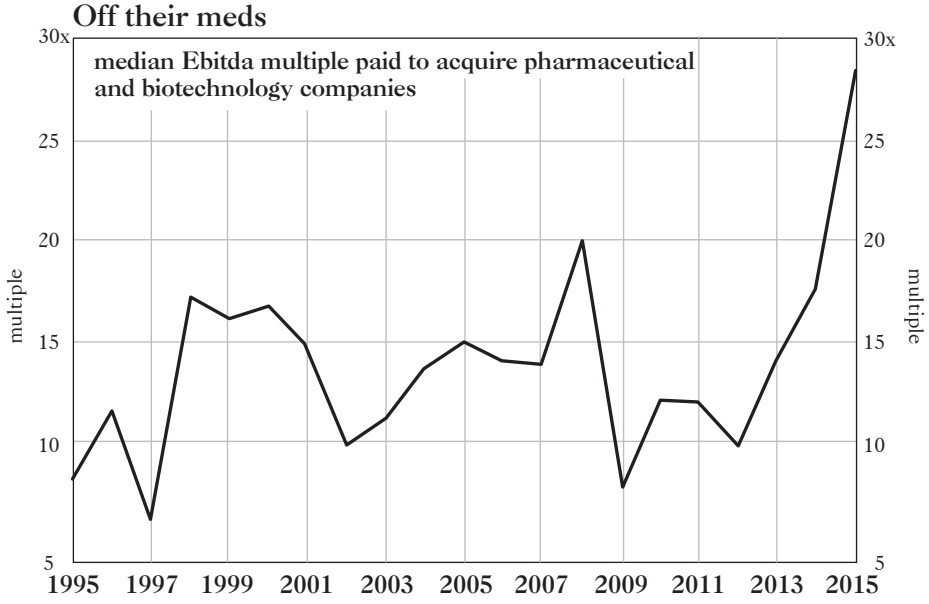
Off their meds



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tion of Restaurant Finance Monitor, "companies like Panera and Wendy's are selling stores to franchisees and borrowing at record low rates to fund share repurchases. Wendy's said it would refranchise 540 stores and increase its leverage to 5x and 6x EBITDA to buy shares, while Panera Bread, in the midst of refranchising up to 150 stores, will borrow up to $500 million to buy more shares [at 30 times earnings] on top of what has already been committed. . . . All of this buyback activity begs the question about rational capital allocation."

Too, it calls into question the vogue in the "asset light" form of organization. As the likes of Endo slash R&D spending on pharmaceuticals, so restaurant executives are selling stores rather than building new ones. "I understand the rationale," Hamburger continues. "Franchisors with few company stores have a higher return on capital. That may be true in the short run, but it's fleeting. Asset-light chains are ceding the future to emerging chains that are actually building stores and taking guests away from them. If you are not growing, you are dying."

Uber is growing, and Lyft is growing. The legacy medallion-cab business is reciprocally struggling. A New York City taxi medallion—that is, a license to operate a yellow cab in the city's five boroughs—was once the acme of investments. In August 2011, Bloomberg reported that the value of a medallion had appreciated by 8% per annum since 1980, outpacing inflation, gold, oil and home prices: "The price kept growing amid economic slumps and stock market declines, rising more than 30% between October 2007 and February 2009, when the U.S. economy was in recession and the S&P 500 index dropped more than 50%." In April 2013, the price of a medallion topped out at $1.3 million.

Naturally, the owners of those reliably appreciating assets did not neglect to hypothecate them. On an estimate by Brian Horey, president of Aurelian Management, loans against medallions in New York, Chicago, Boston and Philadelphia top $3 billion; Melrose Credit Union, Signature Bank (SBNY on the Nasdaq), Medallion Financial Corp. (TAXI on the Nasdaq) and Capital One Financial Corp. (COF on the Big Board) are among the principal creditors. Though a drop in the systemic bucket, those billions are indicative of the temptations presented by the combination of low interest rates and perceived safety of principal.

In the medallion taxi world, perceptions are fast changing. "What makes the assent of Uber any different than ISIS?" inquired a columnist in the March edition of Taxi Insider. The chief credit officer of Medallion Financial resigned in February. Evgeny "Gene" Freidman, the top owner of medallions in New York, has defaulted on a $31 million loan (from Citibank) secured by 90 New York City medallions. In an April 9 letter to all the powers and principalities in New York, Freidman, under the signature of his lawyer, pleaded for a municipal bailout. "An attack on one medallion is an attack on all medallions," the taxi king implored. Early this month came news that authorities had at last discovered the clearing price of a Philadelphia wheelchair-accessible taxi medallion. It turned out to be $80,000, as distinct from the $475,000 price with which the city initially began its auction in October.

The answer to the question we posed at the top of this essay is now self-evident. Mr. Market has relinquished power over the control of financial events to the central bankers—or, if you don't think that Janet Yellen and Mario Draghi actually control interest rates, he has ceded control to the gods.

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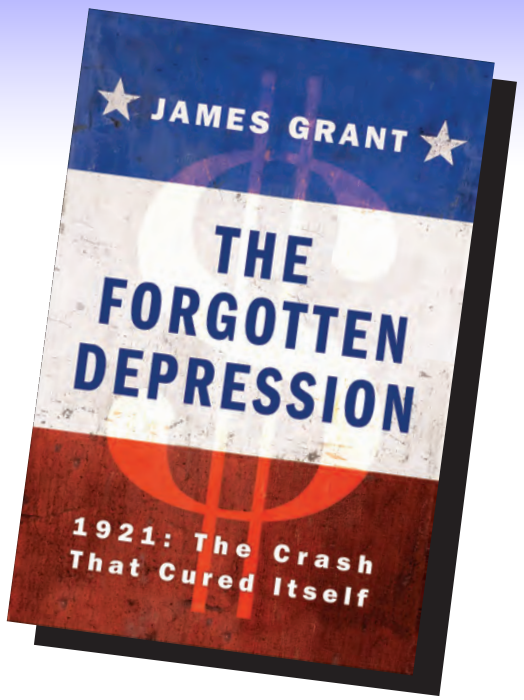
Read the footnotes
Vanguard Group Inc., which beats the mutual fund industry by not trying to beat the stock market, attracted more money in the first 10 months of 2014 than it did in any calendar year of its storied 39-year history. Reciprocally, reports Monday's *Financial Times*, "fewer fund managers are beating the market this year than at any time in over a decade, piling further misery on a profession that faces increasing investor skepticism."
Costs, returns and fads are the topics under discussion. In preview, we judge that passive equity investing is a good idea. It is such a very good idea, in fact, that it has become a fad. We are accordingly bearish on it—bearish in a cyclical vote. We are bearish on passive bond investing, too—bearish in a more than cyclical way. And we are bullish on security analysis—bullish in an unconventional way.
You can't really argue with the Vanguard value proposition. Markets are reasonably efficient, and information is yours for the asking. Active managers, en masse, are not very good at their jobs. Costs are therefore a critical determinant—*the* critical determinant, Vanguard calls them—in achieving investment success. A half-decade's worth of rising asset prices is the evidentiary icing on the cake. "Active management has never been in worse repute," a man from Morningstar testifies. "This is the darkest of days."
Many have helped to dim the lights. We think of Fred Schwed Jr., progenitor of the efficient markets concept in his wise and hilarious 1940 book, "Where Are the Customers' Yachts?"; Burton G. Malkiel, author of the influential 1973 book, "A Random Walk Down Wall Street"; Jack Bogle, who launched the good ship Vanguard in 1975; William F. Sharpe, author of the 1991 monograph, "The Arithmetic of Active Management"; and most recently, Charles D. Ellis whose "The Rise and Fall of Performance Investing" in the July/August issue of the *Financial Analysts Journal* initiated one of Wall Street's rare bursts of soul searching (nothing's turned up yet).
"As we all know," Ellis writes—"but without always understanding the ominous long-term consequences—over the past 50 years, increasing numbers of highly talented young investment professionals have entered the competition for a faster and more accurate discovery of pricing errors, the key to achieving the Holy Grail of superior performance. They have more advanced training than their predecessors, better analytical tools and faster access to more information. Thus, the skill and effectiveness of active managers as a group have risen continuously for more than half a century, producing an increasingly expert and successful (or 'efficient') price discovery market mechanism. Because all have ready access to almost all the same information, the probabilities continue to rise that any mispricing—particularly for the 300 large-capitalization stocks that necessarily dominate major managers' portfolios—will be quickly discovered and arbitraged away to insignificance. The unsurprising result of the global commoditization of insight and information and of all the competition: The increasing efficiency of modern stock markets makes it harder to match them and much harder to beat them—particularly after covering fees and taxes."
The hedge fund business makes an ironic star witness for Ellis's case. In the decade ended in 2000, average annual returns topped 20%, according to Hedge Fund Research via a recent article in *Institutional Investor* magazine. In the five years to 2013, those annual returns had dwindled to an average of just 7.78%, as tallied by the HFR Fund Weighted Composite Index. Individuals who trustly apportioned 60% of their money to stocks and 40% to bonds in a low-fee index fund achieved an annual return of 13.17% over the same interval.
The retired hedge-fund eminence Michael Steinhardt came to the phone the other day to discuss the reasons hedge funds have fallen so short of the high mark he helped to set. The fund that became Steinhardt Partners (it was originally Steinhardt, Fine, Berkowitz & Co.) debuted in 1967. Over the next 28 years, it produced compound annual returns of 24.5% net of fees and profit reallocation, i.e., the standard 1% and 20% hedge-fund remuneration schedule. At the start, Steinhardt observed, there were perhaps 30 funds. Today,

"Hi, I'm rich. What's your excuse?"



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