

Sell to Whom?

So here we are in the middle of June with close to a double-digit return year-to-date in all three of our equity strategies, a tidy position which brings RCB and our clients some measure of financial content, but produces consternation and puzzlement for this *Strategy* writer and the internal research staff.

We are value investors, and as such, we look forward to volatility and audible suffering in the marketplace. Our job is to ease the suffering of investors laboring under the weight of a stock purchased at an unrealistically high price by assisting in the liquidity that enables the transfer of disappointment from over-paying for securities to a new, reasonably-priced home – our portfolios.

But things haven't changed in who knows how many months. Volatility indices in both the stock and bond markets continue to bump along at historic lows. Credit spreads continue to remain tight, which signals the willingness of investors representing hundreds of billions of dollars to suspend disbelief about the condition of the companies to which they are lending. This naturally leads to the continuing parade of mergers and acquisitions, most of which continue to be a simple

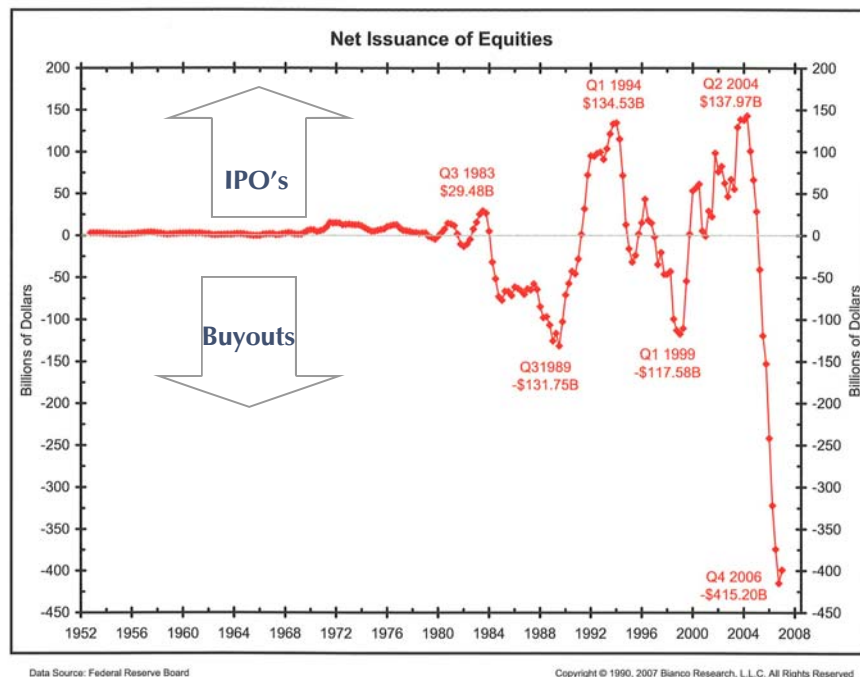
transfer from public to private markets versus strategic industry consolidation. The downturn in real estate continues to grind lower at real estate's historical grinding pace, but big public companies are global in nature, and non-US economic growth in all the usual places and some unusual ones like Europe has remained strong, boosting reported profit growth at a rate faster

than what one sees printed in US economic statistics. All in all, a merry time continues to be had for nearly all, unless of course you have 50% cash or perennially short positions.

So now the usual mid-year question. What positives can be sustained and keep us chugging forward and where are the areas of risk? While we can digress on mere issues like a

slowing economy and rising interest rates, a combination that doesn't seem on the surface to be that helpful, let's get to THE BIG TREND. As noted by the chart above, equity participants have clearly benefited from a simple if not unprecedented supply-demand issue as public companies continue to go private and the remaining handful of public companies are buying back their own stock at a record pace.

As noted by one of our favorite purveyors of data, Bianco Research, the twenty largest days of announced merger activity have accounted for 80% percent of the



Data Source: Federal Reserve Board

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year-to-date gain for the S&P 500. They also note some neat back of the envelope fun in that if you assume that you can lever the \$500 billion in private equity funds by a 7:1 ratio (a “conservative” number by today’s standards), then you can buy the bottom 350 companies remaining in the S&P 500, soon to be renamed the S&P 150.

As we touched on in our last letter, the mergers and acquisitions boom cannot go on forever...and so it won’t. While some with many zeroes in their net worth may differ in this view, we would postulate (again) that companies are being purchased at the highest valuation multiples in reported deal history based on nothing more than these are the highest leverage ratios imagined since Michael Milken was taking the bus every night between Philadelphia and New York dreaming of a high yield world. We would also suggest it is near fact that for thousands of years the business of extending credit has been as much a behavioral science as it has been a mathematical exercise, and one extreme tends to lead in the direction of the other. While it is true that there is just as much money and talent being gathered to take advantage of the supposed-to-be debacle in high yield markets and levered finance as there is money and talent gathered to create the supposed debacle, the perception of change on the margin that there is not a bottomless pool of capital available to take nearly any size company private would likely have unpleasant ramifications for the stock market.

We would like to comment on two additional issues in regard to the buyout trend and its support for current stock prices. The first was beautifully uttered by the former CEO and now Chairman of Spectrum Brands, a company whose fall from levered grace (\$45 per share to \$8...and counting) makes it the front runner for what we will fondly remember as “The M&A Rally of the First Decade of the Twenty First Century.” Spectrum spent four years hoovering up companies at increasingly high multiples of cash flow with increasing amounts of leverage, and then something went amiss. Rising material costs, competitive issues, execution issues – take your pick – all played a part, but the point worth noting is that the practice of leverage and overpaying eliminates your margin of safety should something go wrong on your way to pick up your big check. Spectrum is now faced with the task of selling businesses for quite likely less than what it paid for them from a position of financial weakness into a market that has its knives sharpened. And thus

we quote from former CEO Dave Jones’ locker, “**We are finding it a lot harder to divest businesses than it was to buy them.**”

This brings us back to the concept that nearly every public-to-private deal that is supporting the stock market zeitgeist of today is by textbook definition of the private equity institutional imperative going to require a private-to-public deal “tomorrow.” If the effect is positive today, is it not a depressant for tomorrow?

Yes, we are sick of writing about the same tune (one reason why the author missed a writing cycle of this *quarterly* effort,) so we would suggest the following as follow-up reading. While we recommend going to the original text for some light beach reading, *The Black Swan* by Nassim Taleb (author of *Fooled By Randomness*) can be summed up by briefly stating that “unexpected stuff of a material size happens more regularly than we humans think and our ability to predict the future and the really big unexpected things remains woefully dismal, thus you should always invest with an umbrella in hand.”

Value investing is a recognition of our limitations, and the values we are seeing today, big, defensive, global, boring companies and cash earning 5%, are the kind of investments that have excellent risk/reward asymmetry and will conceptually hold value in an environment that does not appear to be pricing in the existence of the elusive Black Swan, whatever form it takes.

The price to value of our portfolio is “decent” but it is assisted by what we think is the defensive nature of our holdings, a theoretical concept that picked up some actual muscle in the real life application of the price declines here in the first week of June. Our strategy remains unchanged and simplistic: if you don’t get in over your head at the tops of markets, you retain both capital and your wits with which to take advantage of bargains. We are convinced we are in excellent position on both fronts.

What is interesting is that for the first time in about two years, we may be on the verge of doing something in fixed income. Bonds are exactly the opposite of stocks: when stocks go higher, you lean against the wind and lean toward reducing exposure. Bonds are exactly the opposite, the higher “real” (after inflation) bond yields move, the more defensive and better value they become. That is somewhat of a gross simplification, but

we think it is applicable here.

Under the heading of a 51% probability of being macro-economically correct, what we may be witnessing here is “classic” economic cyclicality on a global scale. Global reserve banks are raising rates to lean against strong economies and overheated commodity markets, which is a well-known “take away the punch bowl before a legendary hangover” move. Whether or not our own Federal Reserve has to follow is frankly not the question of the day, as markets have moved ahead without waiting for Federal instructions. We would suggest that all these moves are “end of cycle” moves, to be followed by global economic weakness.

It is an old trader’s joke that “the market” will find the weakness of your portfolio and punish you unmercifully, as in “the economy will be fine as long as interest rates don’t go up and really murder the idea that housing and real estate are bottoming,” or “as long as credit spreads stay tight, private equity deals will get done and stocks are fine.” Viewed in this light, the current back-up in interest rates certainly cannot be seen as helpful.

Despite the appearance of these 2500 words to the contrary, our job is to accept the cards the market is dealing and play the undervalued ones, regardless of the headlines. As Howard Simons of Bianco Research noted, “Don’t bet on the world ending. It is only going to happen once and how are you going to collect?”

It seems too easy to go from *The Black Swan* to the upcoming IPO of Blackstone, but we’ll manage. While our timing is not necessarily better than anyone else’s, we will dare to say “this is the top” of the M&A cycle, and seeing the Chinese government – with its record amounts of depreciating dollars burning a hole in its pockets – signed up to pre-invest \$3 billion in that IPO, is truly the cherry on that top. And let it be noted that we are not picking on Blackstone as KKR, the Carlyle

Group, Apollo and the Texas Pacific Group are rumored to be next in line.

We have noted in the past that there is no investment idea that is so great that hundreds of billions of dollars of new capacity to pursue it can’t ruin the hypothesis and return assumptions. Blackstone is not immune. Almost by definition, a desire to create an ongoing “institution” – versus the preservation of a free-wheeling, personal enrichment program which it has so successfully pursued in the past – clearly states, “Our past returns will have no bearing on what we will earn in the future – they will be lower.” The prospectus clearly states a desire to build out additional capabilities like more traditional money management

and fund of funds activities, neither of which has history on its side in regard to some proprietary means with which to consistently manufacture returns far in excess of other highly educated and motivated financial players. The actual structure of the deal as far as even the barest mention of the most basic corporate governance issues is “interesting” to say the least.

And lastly, and this is juicy, is the issue of how Blackstone is intending to account for its far-flung empire. The Financial Accounting Standards

Board is now up to at least 159 rules as to how companies should account for their activities and it is FASB 159 where Blackstone is going to make its mark. Blackstone receives fees on the money it invests plus a percentage of the profits on its deals, a term known in the private equity world as the “carried interest.” Notwithstanding some noise in Washington that may attempt to tax carried interest at personal income rates versus as a rightful capital gain (a black swan if I ever saw one), there is an accounting issue as to how Blackstone will record its carried interest. Most mortals would suggest that if you invest money in a private company, you book your profit when you sell and receive the cash, given the uncertainty of future success



and the difficulty and vagaries of self-valuing your own investments. Given the structure of the private equity business, where the fund's return is comprised of all of the investments within it, fund sponsors often holdback some of the profits of early deals just in case some of the later deals don't work out, allowing investors to "claw back" earlier performance fees.

Not so for Blackstone. If I have read their prospectus at least one of the six times correctly, they are suggesting the following: "We invest one billion dollars. We assume on day one of that investment that we will earn our usual 30% annualized rate of return for the next five years and thus our initial investment will be worth \$3.7 billion five years hence. We are entitled to earn 20% on that \$2.7 billion which is \$540mm. We put the present value of that back on our balance sheet and then amortize the \$540mm carried interest quarterly over the next five years on our income statement. Oh, we will evaluate quarterly our investment using our own undisclosed criteria and mark its value to market and let you know." In other words, Blackstone can manufacture essentially whatever earnings it would like to, and their structure is such that there will be little that "partners" can do as far as demanding disclosure.

Now I know "shoot the lawyer" jokes have been popular for many years, but if this practice becomes legitimized for money management, we can insert accountant in that statement right now. If one excludes the variety of criminal offenses committed at Enron, one of the entirely legal but in retrospect egregious abuses of accounting conventions was the practice of transferring assets valued at X to a related entity at 3X because their model "knew" that these assets would be worth 3X, so why not just book the 3X now. In all fairness, every publicly traded financial institution uses FASB 159 to some degree and not every asset on Goldman Sachs' books to have three easily available liquid quotes with which to document a reasonable and third party estimate of its value. But this is pushing it. Blackstone's stated reason for utilizing this accounting treatment is that it will smooth out the inherent lumpiness of private equity deal flow and make it easier for public investors to understand their business. This is of course the same language Blackstone uses to take companies private – escape the tyranny of the supposedly insatiable demand of the public markets for linear profit production. To quote Samuel Johnson, "it is both original and entertaining, but the original part is not entertaining, and the entertaining part is not original."

(Now this is interesting, entertaining and original! As we were about to hit the send button to deliver this piece into the world, Blackstone filed an updated S-1 that retracts the entire FASB 159 approach to their accounting, and thus subtracted \$595mm from 2006's pretax earnings. With this mere bit of accounting ephemera put to rest, we are sure the IPO will now triple instead of double in this environment.)

What is particularly antithetical here is that Blackstone (the private equity shop, not the soon to be publicly traded version) is right, it is the height of inanity to suggest that life and financial returns are linear and must correspond with the regular revolution of this planet around the sun. Besides the obvious long term record of Blackstone in private equity, there was a superbly interesting study in the *Wall Street Journal* recently documenting a study done with Morningstar in regard to the demise of star investment manager Bill Miller's record of beating the S&P 500 for 15 consecutive years. Who's next?

Well, they found only seven diversified funds that had eight year streaks while other asset classes went as far as seven consecutive years of beating the benchmark. How about an easier question: which funds were in the top quartile of performance every year for ten years? Answer: zero. How many funds were in the top third every year? Answer: zero. You had to move the line to the top 50% every year to find a handful of money managers. Yet over 600 funds beat the S&P 500 net of fees on a ten year annualized basis.

In other words, the promise of double digit long-term returns with little or no near-term volatility is in and of itself a statistical anomaly that is marketed by many, but highly unlikely to be achieved in reality over any extended period of time. So, as an aside we humbly ask, in a world where people are lining up to beg private equity and hedge funds to let them in and pay 2% fees and 20% or more of profits with multi-year lock-ups, why do we still get the question, "how are you doing this quarter?"

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