THE WHITEBOX MARKET OBSERVER

JANUARY • 2005

The Cult of Equities

Why are private accounts for Social Security a far more realistic and popular idea today than they were even in 2000 at the height of the boom?

Ronald Reagan first proposed partly privatizing Social Security in 1976. President Ford ridiculed the idea; no one really could be gotten to take it seriously. This might have been because the country was coming off a couple-decade stretch wherein putting one's money into common stocks seemed to have been a manifestly bad idea (though the payoff was just around the corner). Four years later Reagan was elected and the great boom began. Even then private Social Security accounts did not become a serious political idea.

Bill Clinton was one of the most fiscally conservative presidents of the twentieth century, artfully letting a Republican Congress shove him into the briar patch of budgetary restraint and even reforming welfare. He was in a better position to straighten out Social Security than any Republican. Yet even at the top of the greatest bull market in history, private accounts were not seriously on the radar screen.

Now they are. Our guess is that they are at least even money to happen in some form. On the whole, we are glad, but the current framing of the issue seems to us to obscure the two things that are really happening.

The first is that Social Security as we have known it isn't being reformed—it is being abolished—or rather the cover for its inevitable demise is being established. It is being allowed to die because it was created as a welfare program for poor people and is completely unsuited to serve as a pension program for the middle class, its current purpose.

The wise men of the *WSJ* argue that funding the transition to private accounts with a few hundred billion or even the odd trillion in government debt will not so much increase the net obligations of the U.S. government as begin to put trillions of unfunded obligations on the books. That's true if one considers projected S.S. benefits as actual obligations of the government, as the *Journal* urges us to. But a political promise is not a full faith and credit obligation; welfare programs are not pensions; Congressman cannot be sent to jail for reneging on promises or changing policies. All the fretting about the consequences of Social Security "going broke" as if there were anything there to go broke is plain nonsense. Promises and schedule of benefits that were once useful are not anymore. Inevitably either benefis will be too nigardly for future middle class retirees or costs will be too high for middle class taxpayers. It's better to accept that Social Security is obsolete rather than spend trillions more fending off a mythical "bankruptcy" that would have none of the consequences of the real world version. The best argument for private accounts is that as they grow in size and consequence they will gradually render tolerable the inevitable winding down of the old program until it dies or is rendered de minimis.

Capital is not much use without something useful to invest in.

Nevertheless—and here is the other important issue that's not quite being grappled with—private mandated Social Security accounts are not free market capitalism. The largely un-remarked core of this entire notion is that for all practical purposes U.S. citizens will have been placed under a legal obligation to invest in the stock market. And at least for the transition period that investment will be financed by the U.S. government. Effectively U.S. taxpayers will be making an obligatory leveraged investment in equities with the government as guarantor.

The result, all other things being equal, is that prices will rise from already frothy, not to say bubbly levels, and earnings yields (the S&P last week was returning a pathetic 4.87 percent) will decline even further. Or to look at it from another direction, U.S. corporations will have even cheaper access to capital.

Is this a good thing?

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Broadly speaking, a society that saves more and invests more will get richer over time. But this process is far from smooth. Capital is not much use without something useful to invest in. A very substantial minority of U.S. corporations burn more wealth than they create every year. Absent some pent-up demand of good projects going unfunded a sudden and arbitrary infusion of new capital would simply fluff up prices. As workers operating more or less under compulsion buy in, who will cash out? Not the money managers and institutions that are professionally committed to equities. Corporate insiders are far more likely candidates. In effect, by a combination of subsidy and compulsion, the government will be shifting share ownership from the knowledgeable to the uninformed, from the canny to the gullible. Joe Paycheck will be forced by his government to buy out Johnny Capital Gains at Johnny's price.

So why isn't Joe Paycheck objecting?

There can be only one answer. Five years after March 2000, the cult of equities lives.

The cult of equities lives today because the Fed (to its credit, given the choices) engineered about as soft a landing from the crash as one could have possibly imagined. As Churchill noted, the experience of being shot at without effect is wonderfully exhilarating. It's especially fun if the bullet-proof vest is woven from hastily printed dollars. Perhaps that explains bullish sentiments sitting at an all time high less than five years after the second-worst cataclysm in stock market history. It took five decades after 1929 for Joe Paycheck to get back into the market in a big way. This time it took about five months.

Positive feedback loops are the essence of business cycles. The cult of equity was preserved by the Fed virtually forcing money back at stocks. The resurgence of the cult is now making Social Security private accounts a realistic possibility, which would tend to divorce prices even further from the reality of returns. And though a private accounts program would at first have little direct impact on demand for equities, prices may well get up and run simply on passage of the plan in anticipation of future demand.

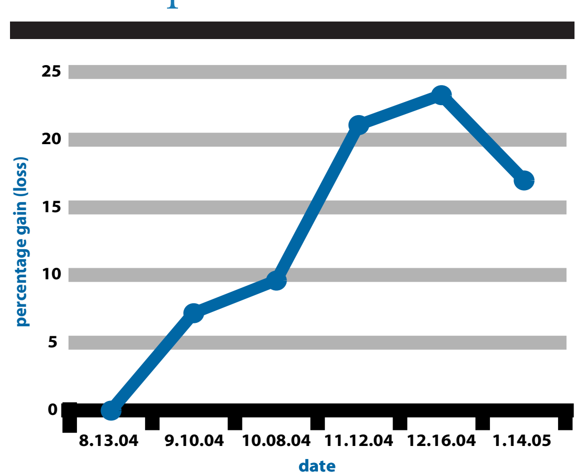
We face not a bubble but a blob.

It was far easier to find underpriced stocks even in 1999 and 2000 than it is today. If that sounds surprising, recall that the bubble, like most, was a bubble in a particular sector: tech and Internet stocks. Much of the money flowing in to new economy stocks was flowing out of old economy stocks, creating some excellent bargains. That's not the case today. Though large caps have lagged for the last several years, overpricing is spread far more evenly throughout the market now than five years ago. We face not a bubble but a blob.

But bubbles or blobs, they all deflate eventually. One scenario we can imagine is that a private accounts bill passes, prices run on the news, and then the reality of net inflows disappoints, prompting a collapse. However it happens, if it happens one wants to be in on the kill. Meantime, the market as a whole is not so tempting to make us want to let go of cash that could be a lot more useful sometime in the next year or so.

Our current proposed asset allocation includes 25 percent to the most lucrative cash equivalents practical. This seems more than ever like a good idea to us. In the nearly three years we have been publishing this letter, it was possible to record gains of several hundred percent cycling through stocks we have covered, but the vast majority of those gains would have come inside about 14

WMO Apartment REIT Index



months from October 2002 to roughly the end of 2003. That, not the mythical 9 percent average annual return over 100 years, is the reality of the market. There is almost nothing more important to do than to preserve cash to have around when bargain day arrives.

As to the rest of our allocations, neither the sectors nor our world view are much changed. We still think the future contains more inflation than the immediate past, or rather that we will see continued evidence of the inflation that has already occurred. Despite modest official inflation figures, the signs of too much money are everywhere. The gold, commodity, and currency stories are too well known to recite here. But wasn't it interesting that one of the bits of news that helped drive oil back down from the orbital 50s to the merely stratospheric 40s was the revelation of unexpectedly high inventories? It's not just oil. One keeps running into high inventory anecdotes, all a little surprising given the several-decades-long trend the other way, of "just in time" inventory management only recently intensified by the inventory dread of the post-bubble contraction. The *WSJ* finally did a story on it the other day, noting that in an environment in which money costs less than anticipated commodity price rises, it pays to stockpile.

We still see an outside chance of that inflation becoming severe, especially due to political instability. (Staunch conservatives though we are, the Republican Party is the most overbought stock in the market right now.)

Big Pharma is still remarkable for being an underpriced sector in an overpriced market and still has more long-term appeal than almost anything we can think of. It certainly deserves 7 percent of our assets if not more. Lilly has come down from the nosebleed territory it habitually occupies. We were tempted to add it to our basket, rounding out the six companies we want in there. We decided to wait and see if it doesn't become really cheap as opposed to just cheap for Lilly. Our 7 percent each in oil and steel are supported by inflation with an upside in China.

We have gone through two decades of watching the financial industry create new forms of liquidity to purvey.

We have 20 percent in apartment house REITs which were up so much that we were just considering selling some off when they sold themselves off. We think they are fine for now and we like the dividend yields at our purchase price. If they pop again we might sell some off and increase our allocation to near cash.

The one blank left in our program is our proposed 7 percent allocation to financials. Why financials? A better phrasing is "why not financials?" Compared to the market, we are severely underweighting the sector. Something like 20 percent of the S&P market cap is in financials; we are proposing 7 percent. We are not enthusiastic about the sector, in part because of inflation fears and in part because of our devotion to Stein's law: "If something can't go on forever it will eventually stop." We have gone through two decades of watching the financial industry create new forms of liquidity to purvey. It's hard to think of what could be next and it's even harder to make the case that the demand for liquidity can continue to grow at the remarkable pace of the last twenty years. Computers have already been invented once; derivative markets have already been created once; everything that isn't nailed down and quite a few things that are have already been securitized. Inflation is a condition in which the supply of liquidity exceeds the demand for it—bad news for liquidity providers.

We are doing our modest 7 percent mostly as, well, a gesture toward modesty, a hedge against the possibility that one of our biggest ideas, that the era of the financier is coming to a close, might be wrong and that we are imagining this inflation thing.

Moreover, in an overvalued market financials do look a bit cheap, at least on the surface. On the other hand, they almost always do, at least on the surface. Scan through the PEs of perfectly respectable banks and insurance companies, including quite a few large ones, many with all the marks of true quality including long records of smooth and rising earnings and rich ROE, and you will probably be struck by the positively anemic PEs especially in this fat market. Bank of America can be had for a PE of around 12. Allstate also rates only a 12 with a forward of 9. Everest RE, a decent sized re-insurer trading near its all time high, scores a PE of less than 12. We could list dozens more. Nor are these numbers unusual. On an earnings basis these companies are almost always cheap compared to the market.

Most financials are black boxes bearing unknown and essentially unknowable credit, interest rate, and asset quality risk. All an investor really has to go on is track record and even that is dicey: the records are created by people who understand money too well for their investors' good and who hail from an industry that was fanatically image conscious even back when few financial institutions were publicly traded companies. The cloud of unknowing imposes a permanent discount on these prices. On the other hand, with the rest of the market so fat, the current earnings yield on these companies is at least some compensation for owning them.

If we have to do financials, however, we prefer to do them our way, which is to overweight insurance companies. Insurance is an inherently better business than modern banking. Customers are less demanding and often act out of financially irrational motives. Barriers to entry are not huge but they are much better than for banks, thanks to the meddlings of fifty state insurance regulators. There are lots of non-bank banks competing with Citi and BoA—non-insurance company insurers are a much rarer breed.

Also we think the near future will be kinder to insurance companies than to banks. Logically as interest rates and thus investment income rises, insurance premiums should fall. But while the rise in investment income should be swift and nearly automatic, premiums tend to be fairly sticky. For a while at least rising rates should favor insurers.

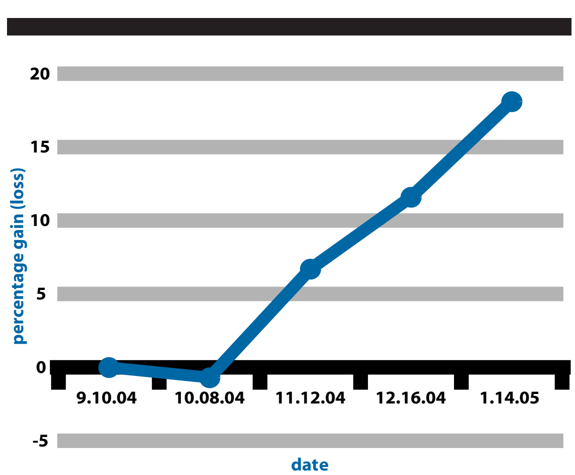
So who to buy? Remember these companies are black boxes. You really can't know what you are getting. So we suggest acting on a few rebuttable presumptions. Book value is a useful metric for financials. Unlike say manufacturing or technology companies, which tend to be worth either a lot more or a lot less than their tangible assets, financial companies basically are their tangible assets, plus brand. In the absence of outright fraud, buying near or even under book value provides a margin of error. This is often possible with insurance companies; banks tend to sell for a lot more than book, in part because their liabilities tend to be overstated and in part because they are fee-making service companies. And it is reasonable to assume that big old companies with long good records are more stable than small new ones with short uninformative records.

Remember these companies are black boxes. You really can't know what you are getting.

What we think makes sense is to put maybe half of that 7 percent into individually selected insurance companies, looking particularly for big, long-lived firms that for some reason or other are currently selling near or even below book. That will usually mean they have had some recent trouble: hurricanes, regulators, mergers the market dislikes. If the discount seems disproportionate to the trouble, they may be bargains. Two such at the moment are the newly merged St. Paul Travelers and AIG.

STA is cheap for three reasons. The best is that share prices throughout the sector got smacked by Florida: catastrophic losses

WMO Steel Index



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are almost always a buy signal in this sector. (We've sometimes been tempted to see if we could make a living just by buying insurance companies in hurricane season.) More specific to STA are some well-publicized post-merger glitches that may actually have cost the company business in the commercial lines. Once again, that's the kind of problem we usually like: depressing the share price in the near term but eminently fixable. The third and potentially most serious is the possibility that the company is under-reserved on asbestos, and, less seriously, on its surety policies for contractors that helped make such a mess of the Big Dig in Boston. Even here, though, there is a potential upside. The company made very large additions to reserves as part of the merger at least somewhat ameliorating the issue. It looks reasonably likely that there will be some political help on the asbestos front. Finally, though these reserve issues are large enough be a real hit on earnings in a given year, none are worse than that. As we write St. Paul is at about 115 percent of book value, compared to about 145 percent for the sector, more than compensating for any necessary additions to reserves.

AIG is no longer being given away for free as it was immediately after the bid-rigging scandal broke. That would really have been the time to buy. But with a trailing PE of below 16 and a forward of below 13, $67 is still a nice price to pay for a company with a long and lovely earnings and growth record, an ROE in the low teens, merely collateral exposure to said scandal, and a rare potential for multiple rebound given the company's growth history and prospects.

And don't forget PTA. We are covering it as a special situation, but it fits nicely here too. It is not large or old, but having been recently subjected to serial colonoscopies from dozens of state regulators, it isn't a black box either. It is still selling at a huge discount to fully diluted book, and we love the growth prospects of its business line: long-term care insurance.

What else? We are going to look at small and regional banks in a future issue. But remember this is the black-box sector. Knowledge justifies concentration; ignorance demands diversification. If half our 7 percent is going into these three insurers, there is a decent argument to just stick the rest into a fully diversified financial sector ETF. (You can tell how much we love this sector, huh?)

THE SUTURA SHAMBLES

No, we don't mean that. The product is terrific. The growth prospects stupendous. We love it. But the reverse merger process is a little messy as promised. And then there is the CEO, Tony Nobles. We are confident he is for real as a medical device guy and even an entrepreneur. But he is not, well, buttoned-down. Ask Tony what two plus two equals, and he'll tell you "Four!!!!" and sound like he is hyping the results while telling the Gospel truth. On the other hand everything he has said to us so far has been true, especially about Superstitch, the Sutura device for suturing arteries opened even several inches below the skin for procedures such as placing a stent.

Still imagine our chagrin a couple weeks ago when a reader brought to our attention the following passage in a book by short-seller Manuel Asensio:

> Harry Moll passed control of Turbodyne to his longtime associate Logan Anderson, who in turn passed control to Leon Nowek. Nowek had been associated with Moll in Northfolk Ventures Ltd., which ran into regulatory trouble in 1992 after its founder, Dr. Anthony Nobles, was found to have falsified his academic credentials.

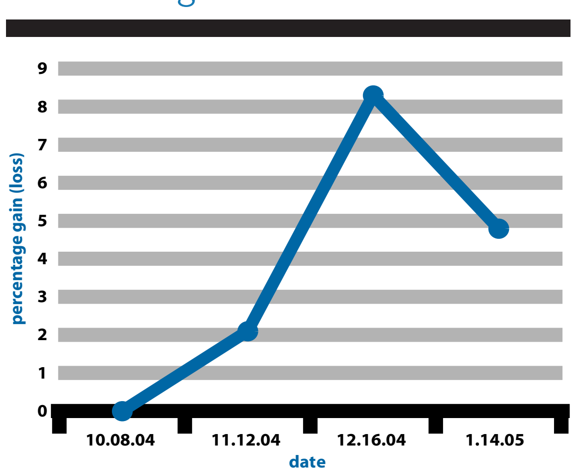
As we observed on our blog at www.whiteboxstrategies.com the most unsettling thing about this was not that Nobles as a much younger man at some point hyped his credentials—he is enormously accomplished anyway with for instance more than twenty U.S. patents to his name and more to come—but that he was in some way tied into Harry Moll, an infamous promoter working out of the just as infamous Vancouver stock exchange. We asked Nobles for an explanation and we got it in the form of a letter his lawyers send out when the subject comes up. Within the obvious limits it is a pretty good letter. Yes, Nobles did inflate his academic credentials, and, yes, the promoters used that information in a disreputable and manipulative way. But Nobles did not know what they were doing with the information, had no clue they were scoundrels, and at that point being completely naïve on the financial side had no clue the Vancouver exchange was a hangout for scoundrels. In any event Nobles paid the price: he was forced out of companies he created by the same crew of scoundrels that once hyped his qualifications to investors.

Knowledge justifies concentration; ignorance demands diversification.

Besides the fact that this letter comes from a large and, as law firms go, respectable source (so we damn with faint praise), Baker and McKenzie, and the fact that the explanation has long satisfied Goldman Sachs and other backers, it rings true to us. We can just imagine the young Tony Nobles, smart as a whip, an inventor/entrepreneur, who sets himself outside the establishment because he thinks he is smart enough to do without it, but who finds out repeatedly that what the world really wants is those paper credentials he never bothered with. He's just as smart or smarter than those guys. He's done what they have done and more. He has what those letters mean. So what the heck? They are just letters.

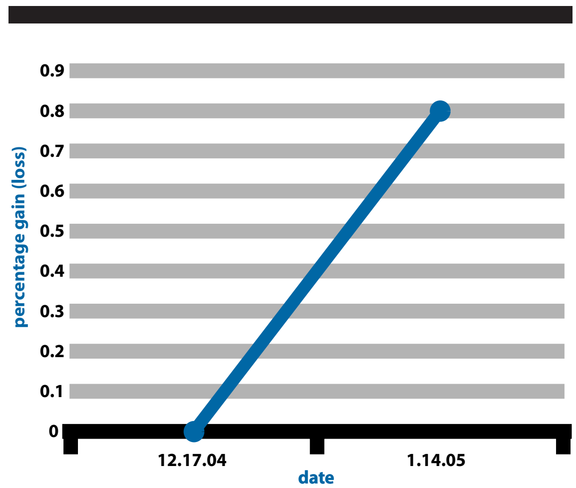
If it were just our own money, this would be a non-issue. We don't really care about the 1992 incident; it hasn't affected our own intentions on Sutura. We're writing about it here because we introduced our readers to this company and to Tony Nobles and we want you to know what we know and make your own decisions.

WMO Big Pharma Index



On the merger. Our reference to "mess" above does not mean we think the merger is not happening. It seems quite likely to happen. The mess was the lack of clarity from all parties on the exact diluted share count for TVGR, from which one figures the implicit post-merger market cap looking at TVGR's share price today. The short answer is that TVGR's final share count will be 141.1 million (which will be shrunk at the time of closing via a one for twelve reverse split). Since TVGR will get 5 percent of the final company, you can figure the implied market cap from there. At the time we first wrote, with TVGR, at 7 cents the implied market cap was $200 million, almost double what we believed at the time. Today it is somewhat higher.

WMO Oil Index



So is it a good deal? Maybe. If this company works it will certainly be worth several times its current implied value. But patience is such a good thing. Everything gets cheap from time to time and start-ups especially. New sales force. New production facilities. Volume ramp-up. What are the odds that these guys will never have a bad news quarter or even that Mr. Market will never freak out on the downside for no reason at all? IFLO was selling for less than $10 last July.

What are the odds that Mr. Market will never freak out on the downside for no reason at all?

Plus there is this big problem with TVGR. Pennies. Nobody can count in pennies. Stock jumps from 7 cents to 11; what the heck—that's only 4 cents—it's still free. Right. It's a 57 percent move. Although the cliché is that penny stocks gain value from reverse splits that make them seem more real, and though logic suggests that the price should rise once the merger is actually done, it makes just as much sense to us that the price will drop once buyers are counting in dollars and fretting over reality rather than fantasizing over prospects.

TWR'S DEAL

Briefly on TWR: as noted on our website the company did get approval on that first $50 million tranche of the AR securitization program it is seeking, with net proceeds of $44 million. That substantially improves their liquidity. There is potential to expand this to $200 million, pending ongoing negotiations with the same creditors who eventually agreed to allow Tower to close on the $50. In addition TWR is negotiating for a $30 million AR facility in Europe, permitted under its existing credit agreements.

The $44 million considerably improves the company's position; they probably don't need the rest of the money—unless more bad things happen. We stand by our view which is that if TWR made it into the New Year the company would survive. The quarterly conference call could be huge. If there has been no more bad news we would expect the share price to begin recovering fairly quickly. If the quarter's news is ambiguous then we will probably have to wait for another catalyst.

—Andrew J. Redleaf and Richard Vigilante

January 14, 2005

Special Opportunities

As you know we have abolished our old WMO Model Portfolio because our lawyers hated it. But uncovering and staying on top of unusually promising stocks is still our major focus. Currently we are actively covering all the stocks that were in the portfolio as of last issue, except for the shorts. We will continue to update them just as if the portfolio were still active. For a reminder the current list includes ACP, ALDA, BSET, BWNG, DRRA, IFLO, PCL, PTA, SMF, SPAN, TALK, TOX, TWR.