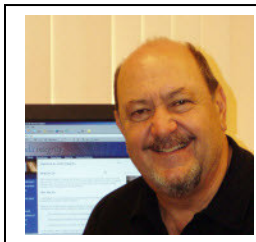


CHAIRMAN'S CORNER

by James A. Kaplan



The Last Decade – Part II Risk: When to Hold ‘em, When to Fold ‘em

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As we approach the end of the decade, it's obvious that the past ten years have presented stakeholders with opportunities for substantial gain and substantial loss, and that the distribution of those gains and losses has been very uneven.

- ✓ The start of the decade greeted us with the arrival of a revolutionary new technology: the Internet. In the late 1990's the market began to notice the Internet was becoming a pervasive tool for the distribution of information and interactive communication, and investors were soon intoxicated with what seemed limitless applications of this tool. Market returns from 1997 through 1999 averaged over 27% per year, largely driven by the market's exuberance over new technology. Giddy with returns, few investors questioned the arbitrary nature of business models into which billions of dollars were poured.
- ✓ By the year 2000, this exuberance had begun to deteriorate. Technology continued to improve, but the market recognized that the value of new technology companies had been grossly overestimated. Market values tumbled, with the S&P dropping 40% from 2000 to 2002. Small-cap stocks dropped even further. Investors who mis-timed the extreme volatility found their holdings were now worth only a fraction of what they had paid.
- ✓ Between 2003 and 2007, the U.S. Federal Reserve and foreign governments began expanding the money supply at an accelerated rate (a process that continues to this day). Easy money encouraged asset speculation and ever-increasing leverage. Once again, initial success led to excess. As returns went through the roof, instruments were traded at prices that far exceeded their potential return. This speculator's market collapsed in mid-2008, and took the global economy down with it. Inflated stock prices fell precipitously, particularly among those companies that were over-leveraged (e.g., Lehman Bros., WaMu, Bear Stearns). Once again, investors who knew how to read the signs had made millions; most of us took a loss.

Since March of 2009 the financial crisis appears to be abating, at least in part, and market prices have again turned upward, but as I noted in Part I of this article (published January 14, 2010), the net of all these vibrations of huge magnitude is a great big Zero in stockholder returns. The Dow has limped back to the 10,000's but investors are wary. The decade of the "aughts" has brought no solid advances to indicate economic growth. Instead, it has brought a series of seismic events that have damaged countless bystanders and left the investment markets confused about where the next blow is coming from.

Risk, in and of itself, is only dangerous when it's undetected. The problem is simply that most of us don't understand the risks associated with our investments. Stock prices are self-fulfilling; the illusion of profitability will always attract buyers, driving prices higher until a company implodes from hidden financial stresses. Again and again in the past decade, we saw substantial risks taken which failed to produce substantial return. Few investors benefited; most were harmed. The collateral damage – vanished retirement funds, foreclosures, unemployment, hunger – will be with us for a long time.

Risk-taking is a symmetrical proposition. The greater the potential reward, the greater the risk an investor may be willing to incur. No informed investor takes risks without the expectation of compensatory reward. And yet, whether it's Internet IPOs, the Madoff fund, or Credit Default Swaps, investors will run to the next opportunity for speculation, gambling that they can score a big win before their investment turns to dust.

The latest instance of thoughtless risk-taking is in the high-yield bond market. According to Merrill Lynch, high-yield bonds returned 52.15% over the trailing twelve months ending January 15, 2010.¹ During this same time period, intermediate Treasury bonds with similar maturities to high-yield bonds have declined 4.02%. The spread between these normally matched indices exceeds 56% over a one-year period!

Only one year ago our economy faced a complete meltdown; while the worst may have passed, we are still faced with high unemployment, slack demand, illiquid asset bubbles, and unprecedented government borrowing. As pointed out in the Wall Street Journal², "Private equity-backed businesses are paying their owners dividends out of new bond issues" – robbing not only Peter, but everyone else to pay Paul. In all, companies raised \$11.7 billion in bond issues during the second week in January. This amount exceeded the \$11.4 billion prior record during the credit boom of 2006.

This is a serious worry, and is only exacerbated by the fact pointed out by Moody's³ that the bulk of our \$1.355 trillion in corporate debt is maturing in the next five years. Seven hundred billion dollars' worth of speculative debt is coming due between 2012 and 2014! Who will be spending the 52.15% gain, and who will be blind-sided by risks that were clearly visible all along?

Only a bubble-junky would be comfortable investing in light of today's and tomorrow's hard facts. Don't wake up in rehab wondering how you got there. With quantitative tools readily available, stakeholders can now review a complete risk profile before deciding when to hold 'em and when to fold 'em. I strongly caution our readers to take a long, hard look at the companies listed below. These companies are at risk, not only because of economic events, but because their poor reporting transparency and poor governance may provoke additional negative surprises.

Know when to walk away. Know when to run. Let's make the "aughts" the last decade of burst bubbles.

Table I
New Bond Issues

<u>Name</u>	<u>Ticker</u>	<u>Accounting & Governance</u>		<u>Bankruptcy</u>	
		<u>Risk (AGR®) Rating</u>	<u>AGR Percentile*</u>	<u>Risk Percentile*</u>	<u>Moody's Bond Rating</u>
ArvinMeritor, Inc.	ARM	Very Aggressive	3	1	Caa2/CCC-
Atlas Pipeline Partners, L.P.	APL	Very Aggressive	8	5	Caa2/CCC
Cenveo, Inc.	CVO	Very Aggressive	10	5	B3/B-
Delta Air Lines, Inc.	DAL	Very Aggressive	6	3	BBB-
Eastman Kodak Company	EK	Very Aggressive	1	1	Caa1/CCC
Ford Motor Company	F	Very Aggressive	7	4	B3/B-
Navistar International Corporation	NAV	Very Aggressive	8	6	B1/BB-
Sirius XM Radio Inc.	SIRI	Very Aggressive	9	7	Caa2/B-
Supervalu Inc.	SVU	Very Aggressive	4	4	Ba3/B+

*Percentiles are ranked from 1 to 100, with 100 being highest. An AGR percentile score or Bankruptcy Risk percentile score in the bottom decile indicates greater risk than 90% or more of all North American companies.

¹ "Tracking Bond Benchmarks," *The Wall Street Journal*, January 15, 2010

² "Yield Junkies Return to Bond Market," *The Wall Street Journal*, January 19, 2010

³ "Moody's sees Junk Risk in \$1.4 Trln Refinance Wave," *Reuters*, February 1, 2010