

# FRIEDBERG'S

## COMMODITY & CURRENCY COMMENTS

Friedberg Commodity Management Inc.



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## Fear 'stale bulls', not bad news

Start with the fact that the US stock market is overbought and overowned by no less an investor than John Q. Public. Add to this datum the fact that equity returns have now been negative for three consecutive years. Conclusion? We are in the presence of a huge overhang, one that satisfies *every bid at every level, no matter what the reason*. It matters little whether economic news is positive or whether the US is winning the war on terrorism (were it only so!) or whether Congress, in its infinite wisdom, passes laws that will forever eradicate corporate malfeasance. Stale bulls are on the loose, and only a full-fledged bout of liquidation will put them out of their misery.

In April 2001 we cautioned in a blazing headline "Be warned...a run on mutual funds threatens to accelerate the decline." A few months later we reemphasized that a run on mutual funds was "entirely possible, and perhaps inevitable" and followed this thought with a more detailed exposition on June 3 and on July 31. We based our conclusion on the same premises outlined above: unsophisticated investors – the public – were loaded with stock, and had little to show for it. Note that this technical assessment had little to do with our views on the economy, terrorism (not an issue at that point), or corporate misbehavior. It had everything to do with what in the commodity futures business we call "stale bulls," buyers who have held an expensively acquired position too long and have become disillusioned with the results.

Exactly one year ago to the day, we told readers that "meager investment results – three-year results are already starting to look downright uninspiring – will cause disintermediation. Mutual fund redemptions will accelerate." We were wrong. The public's mania for stocks had hardly abated. Billions of dollars were still to enter funds – \$85 billion to be exact – bent on beating the system via sectoral and stylistic diversification.

This too we predicted when we said that "Wall Street will maximize revenues by continuously suggesting new sectors and new investment fads." Still, we thought that "commissions, fees, and the inability of the investing public to guess the next winner without the wind of rising prices at their back will wear away their faith in equities." It took a full year longer than we thought.

Be that as it may, it is one year later, and investment results have deteriorated even further. Three-year results are

negative to the tune of at least  $-3.94\%$  per annum (compared to a  $+9.71\%$  annualized return on the US TIPS for the same period). Stale positions have grown, and disappointment has become more pronounced. The market's technical underpinnings have clearly weakened further. Failed rallies have added to the creeping loss of confidence.

Latest statistics (see Chart 1) indicate that a run on mutual funds is earnestly underway, in much the same way as a run on banks: The early bird gets the worm. Sooner rather than later, we will hear of difficulties being experienced by mutual funds in carrying out redemption requests, as liquidity begins to evaporate from the "thinner" universe of stocks. A panic will have begun.

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Contributions by Albert D. Friedberg, Steve H. Hanke, Vincent de Caën, and Yakov Friedman.

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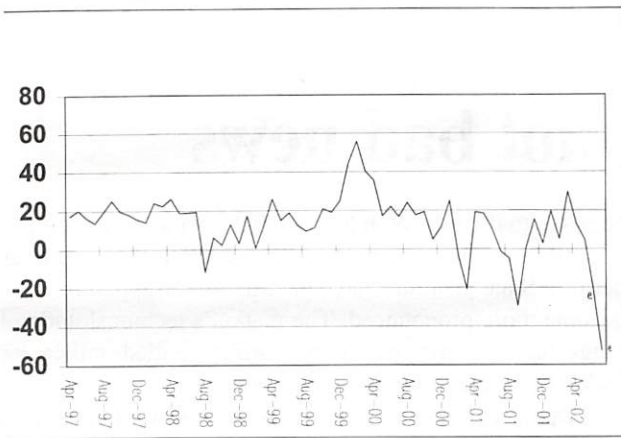
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Forget for now earnings, multiples, dividends, employment statistics, Congress, the Fed, and the hundreds of other tidbits that make up our daily diet of market intelligence and the reason analysts have stubbornly refused to see the hand-writing on the wall (see Chart 2). The fate of the market lies

exclusively in the hands of the public, a public that is becoming increasingly disenchanted.

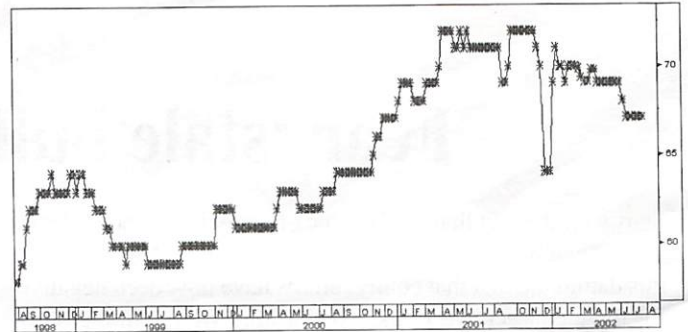
Brace yourself for the inevitable bout of stale liquidation. By the size of the bull position (\$3 trillion, yes *trillion*), it promises to be a once-in-a-lifetime experience.

Chart 1 – Net new cash flow of stock mutual funds (in US\$ billions)



Source: Investment Company Institute (ICI)

Chart 2 – Recommended portfolio allocation: Stocks



**OBSERVER**

# A Hayekian hangover

By Steve H. Hanke

In an attempt to side-step the political fallout from the recent stock market selloff, George W. Bush told us that we were suffering from a hangover caused by the economic follies of the 1990s. While this was nothing more than a crude attempt to get the monkey off his back, it contains more than a grain of truth.

What the economy is suffering from is a Hayekian hangover. Friedrich von Hayek and other members of the Austrian School of Economics developed a comprehensive theory of the business cycle early last century. It reached a pinnacle in 1930-31, when Prof. Hayek delivered his famous lectures at the London School of Economics. Unfortunately, with the publication of Keynes' *General Theory* in 1936, Austrian cycle theory went out with the Keynesian tide. Austrian theory is in the process of being restored to its former sterling status, however. Indeed, it now receives a serious hearing, even in certain central banking circles. For example, in recent years, the Bank for International Settlements in Basel, Switzerland has repeatedly warned that the US economy is in the grips of a classic Austrian business cycle. Accordingly, to comprehend where the economy has been and anticipate its future course, an understanding of Hayek and the Austrians is necessary.

For the Austrians, things go wrong when a central bank sets short-term interest rates too low and allows credit to artificially expand. Interest rates that are too low – lower than those that would be set in a free market – induce businesses

to discount the future at artificially low rates. This pumps up the value of long-lived investments and generates an investment-led boom, one that is characterized by too much investment and investment that is biased towards projects that are too long-lived and too capital intensive.

An investment-led boom sows the seeds of its own destruction and is unsustainable, however. Indeed, on the eve of the downturn investors find that the loanable funds for investments are too expensive to justify commitments they made during the preceding monetary expansion. Some businesses engage in distress borrowing, profit margins collapse under the weight of too much costly debt, and – as if that were not bad enough – many businesses are saddled with excess capacity, resulting from what turned out to be wrong-headed investment decisions. With that, the investment-driven boom turns into a bust. In short, artificially-created investment booms always end badly.

At present, the manifestations of a boom-bust episode litter the economic landscape. Bankruptcies are on the rise, with WorldCom Inc. representing the most spectacular example. In addition, many investment projects have been abandoned or curtailed. For example, a July 19 front-page story in the *Financial Times* reported that the Securities Industry Association, an umbrella organization of investment banks and brokers, postponed an \$8 billion investment to modernize markets.

A Hayekian hangover will vary in its duration and intensity, depending on the degree of the preceding overinvest-

ment/malinvestment binge, as well as the state of confidence that accompanies the downturn or hangover phase of the cycle. During this phase, a central bank's attempts to restart the economy by pushing interest rates down will – contrary to orthodox economic doctrine – only delay the required capital restructuring process and prolong the hangover.

If this hangover phase – working off excess capacity and transforming the capital structure to shorten the length of production processes – is not bad enough, the economy is vulnerable during this phase to what Austrians termed a “secondary deflation.”

If a general feeling of insecurity and pessimism grips individuals and enterprises during a Hayekian hangover, risk-aversion and a struggle for liquidity (cash reserves) will ensue. To build liquidity, banks will call in loans and/or not be as willing to extend credit. Not surprisingly, banks are already scrambling for liquidity. During the past 17 months, banks have been cutting back on corporate lending, shunning especially industries like energy, textiles, steel, and telecommunications that overinvested during the boom.

Moreover, banks are charging higher rates and bigger up-front fees on most other loans, even to top-rated companies. Households, too, are liquidating assets to increase their cash positions and pay down debts. Indeed, they pulled \$13.8 billion out of US equity mutual funds in June. This scramble for liquidity will put a further damper on investment as well as consumption.

Several aspects of a secondary deflation are worthy of further comment. If the forces of a secondary deflation are strong enough, a central bank's liquidity injections can be rendered ineffective by what amounts to private sector sterilization. When people expect falling prices and a real deflation, their demand for cash will increase, soaking up liquidity injections. This has been the recent experience in Japan, where prices continue to fall in the face of year-over-year base money and yen note (cash) growth rates of 30% and 15%, respectively. While milder forms of a so-called secondary deflation don't result in real deflations, they do undermine economic growth and extend the life of Hayekian hangovers.

Even though the primary cause of a downturn is an overinvestment boom, understood in the Austrian sense, Hayek acknowledged that a secondary deflation could ensue and that it could be best understood in Keynesian terms. This is particularly relevant in the current US context.

Prof. Wynne Godley of Cambridge University made this perfectly clear in a July 16 letter to the *Financial Times*. He noted that in the first quarter of 2002, the household sector of the economy was in deficit by 2% of disposable income. Such a deficit, which is unusual, can be financed either by borrowing or by selling assets. With the sinking stock market, high debt ratios, and the current state of confidence, people could easily decide that it is time to put their financial affairs in order. If households' net savings were to revert to their long-term norms, personal consumption, according to Prof.

Godley's calculations, would fall relative to income by 6%. In consequence, consumption, which has been holding the economy's head above water, would sink as investment has already done.

The US is already in the grips of a Hayekian hangover, and the seeds of a secondary deflation are threatening to sprout. Two factors make the threat of a secondary deflation more likely with each passing day: the war on corporate America and the war on terrorism. Past corporate shenanigans continue to be uncovered with alarming regularity. In response, Congress, in a fit of demagoguery, has declared war on corporate America. This has further panicked investors, shattered confidence, increased risk aversion, and set off a scramble for liquidity.

Will Washington's warriors, armed with new legislation and regulations, put a stop to corporate malfeasance? Probably not. After all, the Securities and Exchange Commission has been around since 1934, and as Prof. George Stigler of the University of Chicago has convincingly shown, it has failed to have much effect on the flamboyant falsehoods that on occasion appear in prospectuses and company accounts.

If Congress is serious about protecting investors and rooting out malfeasant corporate executives, it should remove the impediments and lower the costs of mounting hostile takeovers by repealing the Williams Act of 1968. The threat of hostile takeovers (more competition) is the only way to remove the protective cocoons that envelop corporate crooks and incompetents.

Perhaps the most underrated factor undermining confidence is the war on terrorism. Among other things, the war effort has diverted the Bush administration's attention away from virtually all things economic. In consequence, the administration does not have a consistent and plausible economic game plan. And without a game plan, economic confidence suffers.

In addition, there are longer-term consequences. The US is engaged in a war with an elusive enemy and a very uncertain outcome. The only certainties are that this war, as it is being prosecuted, will have a very long duration and will consume meaningful resources. The diversion of those resources toward a war effort will be a drag on the economy.

The medium-term (approximately the next five years) economic consequences of the war on terrorism are analyzed in a recent study, “Economic Consequences of Terrorism,” published by the Organisation for Economic Co-operation and Development (OECD) in Paris. According to the OECD, the war will affect the international economy through three primary channels: a transformation of the insurance industry; depressed trade due to higher transportation costs; and increased government spending on security. It is important to stress that the OECD study is ultra-conservative. Specifically, it assumes that there will be no further terrorist success stories and that there will be no pre-emptive strikes against the likes of Saddam Hussein.

ed at \$30-\$58 billion from the September 11 terrorist attacks on the US. Even though no insurers were forced into bankruptcy, their capital bases took a big hit, and many saw their solvency ratios go to extremely dangerous levels. In consequence, insurers have reduced their coverage and raised premiums by 30% on average, with potential target structures such as chemical and power plants and "iconic" office buildings paying even more.

Many insurers used the terrorist attacks to rationalize government intervention and government assistance. Some countries – such as Spain, the UK, France, South Africa, and Israel – have already introduced government mechanisms to insure against the risk of terrorism. Though these interventions were introduced as temporary measures to be subsumed by the private sector at a later date, many have persisted well beyond their original mandates. In this vein, the United States has proposed a "Terrorism Risk Insurance Act" to absorb excessive losses for the insurance industry. That bill has been read twice in the Senate and referred to the Committee on Banking, Housing and Urban Affairs.

International trade will suffer because of increases in transportation costs. The fear of a terrorist incursion through porous (i.e., trade-friendly) borders has resulted in demands for additional checks and searches at ports and land borders. Thus, "compliance costs" – the cost of collecting, producing, transmitting, and processing required information and documents – are likely to increase by 1% to 3% of the value of traded goods, up from their current levels of 5% to 13%.

Because international trade is quite sensitive to increases in transportation costs – the elasticity of trade flows with respect to transportation costs is estimated at -2 to -3, meaning that a 1% increase in the cost of trading internationally reduces trade flows by 2% to 3% percent – the war on terrorism promises to put a big drag on international trade.

In addition, delays in shipments and other distortions to trade flows resulting from new regulations will disrupt just-

in-time supply chain management techniques developed over the past decade. As a precaution against interruptions in the supply chain, firms may begin to carry larger inventories, requiring new infusions of working capital. If inventories climb to their "pre-just-in-time" levels, the additional carrying cost is expected to reach 0.7% of US GDP.

Increased defense spending is also a foregone conclusion. According to the OECD, higher levels of government spending will erode the post-Cold War "peace dividend" and affect the economy through three channels. First, because increased military spending is most likely to be financed through new debt issuance, long-term interest rates will rise. Second, reallocating capital from the private sector to the public sector will reduce labor productivity. Third, the trend of fiscal consolidation observed since the end of the Cold War is likely to be undermined, leading to negative impacts on long-term expectations.

If you add the lack of a US economic game plan, the war on corporate America, and the war on terrorism to a Hayekian hangover and the precarious state of corporate and household confidence and finances, you have the increasing likelihood of a secondary deflation and a double-dip recession. And if that short-term prospect isn't gloomy enough, consider what promises to be the legacy of George W. Bush's first term: a ballooning of the modern regulatory state, one that will far surpass the dreadful deeds inflicted during the Nixon years. For a sobering account of where that will lead us, there is nothing better than Prof. Hayek's 1944 classic, *The Road to Serfdom*.

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## **GOLD/CURRENCIES**

### **Further thoughts on secondary deflation**

Markets have begun to adjust to perceptions of real deflation. The contractionary effects of the stock market collapse – and, if we are right, the devastating psychological impact of a run on mutual funds – are almost certain to lead to a new recession.

Despite the obvious flight to safety considerations, gold has, as yet, not established enough credentials to occupy a favored position in that hierarchy. Long-term fundamentals still dictate much higher gold prices in months and years ahead (see our May 2002 issue), and present weakness should represent only a short-term detour.

Gold's place will be taken up, near term, by Treasuries. Furthermore, a deflation (even if only perceived, because we strongly doubt that CPI numbers will now or in the near future show a year-on-year drop) should strengthen the US dollar,

especially after its very severe decline. This US dollar reversal however may, unlike our views on gold, represent more than just a temporary correction.

We reason as follows: A consumer-led US recession will narrow the current account deficit, thus reducing the need for external flows. At the same time, lower US asset prices will, at some point, become once again attractive to foreign investors and capital inflows will increase. Finally, deflations are bullish for currencies (for further proof, check the Japanese yen!). A case can therefore be made that the US dollar has seen its lows for the year. *This is still a far cry from endorsing long dollar positions.*

In short, we recommend a temporary abandonment of long gold positions and the liquidation of US dollar short positions.

**TIPS****Portfolio optimization with indexed bonds**

By Vincent DeCaën

This note briefly summarizes the results of the simulation carried out by S. P. Kothari and Jay Shanken, as reported in their unpublished manuscript, "Asset Allocation with Conventional and Indexed Bonds" (working draft, dated 1/3/2002). They conclude that there is in fact an important role for indexed bonds in a diversified investment portfolio, with substantial risk-reduction benefits. Further, if one considers inflation a serious risk in the current environment, as we do, then the anticipated correction can only enhance the attractiveness of indexed bonds.

**1. What is an indexed bond?**

In January 1997, the US Treasury began issuing 10-year bonds that are inflation protected. Both the principal and the interest payments are linked to the consumer price index (specifically, the CPI of all urban consumers). These bonds are therefore known as "inflation-linked," or simply "indexed," bonds.

The introduction of these bonds creates a novel environment for investor asset-allocation decisions. Is there a risk-return advantage in opting for indexed over nonindexed bonds in a diversified portfolio? If so, how is the balance of stocks vs. bonds affected?

**2. Simulation**

Two portfolios were created, one with indexed bonds and one with nonindexed bonds. For each of the two portfolios, calculations were made in both real and nominal terms, for a fourfold contrast.

Because the time series for the indexed bond begins only in 1997, the researchers had to create a proxy: a hypothetical zero-coupon indexed bond. In this way they were able to simulate the performance of the two types of portfolios from 1953 to 1998.

They were able to calculate in this way the real and nominal returns of the two portfolios for different ratios of bonds vs. stocks as well – from 0% bonds all the way up to 100% bond allocation.

**3. Results**

The important question is, to what degree does indexing affect the correlation of performances of stocks vs. bonds? Not surprisingly – because conventional, nonindexed bonds would react to news of inflation much like the stock market – the real return on nonindexed bonds is somewhat positively correlated with that of stocks. The correlation of excess stock returns vs. one-year returns on five-year zero-coupon bonds, based on the monthly series from June 1953 to December 1998, is given in Chart 3.

(Note: "Real" vs. "nominal" here refers to the *whole* portfolio. In the case of the indexed portfolio, there still remains the stock component with both real and nominal returns. As the chart shows, the difference on the indexed side between real vs. nominal is negligible.)

In Chart 3, we observe that the correlation is a positive 0.40 for conventional bonds (in real terms), whereas indexed bonds

are completely *uncorrelated* with the stock markets at 0.07 (in real terms). In other words, there is an important, *differential impact* of unanticipated inflation (or, in the jargon of the authors, indexed bonds "comove less strongly" with stocks).

Further, the real returns on indexed bonds are *less volatile*, an important consideration in risk reduction. Taking the *real* returns on five-year zero-coupon bonds from 1953 to 1998 (Chart 4), they were able to estimate *standard deviations*, the measure of volatility in returns, of 6.27% for the indexed bonds vs. 7.65% for the non-indexed. Thus indexing does provide some protection against volatility.

We also observe that *mean* real returns are slightly lower for the indexed bonds: 2.57% vs. nonindexed 2.81% (Chart 4). Thus, one does pay a slight price for indexing. But the correlation of real returns (indexed vs. non-indexed) is nevertheless a relatively low 0.57 (compared with values in the far right column of the "correlation matrix" of Chart 4). In other words, for the slightly lower return on indexed bonds, the investor also obtains superior protection against inflation.

The comparison in risk reduction between the two portfolios at different ratios (bonds 0%-100% vs. stocks) is set forth in Chart 5. Standard deviations for portfolio returns (variances) are used in turn to calculate the risk-reduction benefits of indexing (covariance). The risk reduction of indexing is found to range from 0% to 26.8% (last row, Panel B). With a 50/50 allocation, for example, the real risk reduction offered by indexing is 12.0%.

**4. Conclusion for portfolio optimization**

Finally, they compare the results of the simulation for the two portfolios in terms of *optimal allocation* (Chart 6). For non-indexed bonds (Panel A), an optimal allocation would be up to 30% bonds (fourth and fifth rows, maximizing the ratios at 0.36 and 6.0). But because more bonds means lower returns, somewhere in the neighbourhood of 10% bonds is recommended by the authors.

However, when indexing is introduced (Panel B), the optimal allocation to bonds jumps to 60%-70% (again, maximizing ratios in fourth and fifth rows at 0.41 and 6.9 respectively). The contrast in allocations is stark. Even allowing for an inflation-risk premium of 50 basis points (Panel C), the optimal allocation is still at least 50% bonds (0.37 and 6.3). We can split the difference and call it 60%, give or take.

On the basis of this study by Kothari and Shanken, we must conclude that there is a crucial role for indexed bonds in portfolio diversification. Many investors, such as retirees, are unduly exposed to inflation risk, and could derive substantial risk-reduction benefits from indexing. The magnitude of such benefits varies, of course, with the inflationary environment. But if we are correct that stagflation is a real threat (see my article "On the specter of stagflation," in our March 2002 issue), then indexing becomes attractive indeed.

Chart 3

**Correlations between real and nominal excess stock returns and indexed or non-indexed one-year returns on five-year zero-coupon bonds**

Indexed bonds		Non-indexed bonds	
Nominal	Real	Nominal	Real
-0.09	0.07	0.25	0.40

Estimates based on monthly series of one-year historical excess returns (non-indexed bond/stock) or simulated excess returns (indexed bond) from June 1953 to December 1998.

Chart 4

**Descriptive statistics for annual overlapping bond returns from June 1953 to December 1998 (N = 547)**

Statistic	Indexed bonds		Non-Indexed bonds	
	Nominal return, %	Real return, %	Nominal return, %	Real return, %
Mean	6.76	2.57	6.92	2.81
Median	5.66	1.93	5.30	2.05
Maximum	29.81	24.94	35.64	29.59
Minimum	-12.52	-20.15	-7.90	-17.11
Standard deviation	7.01	6.27	7.22	7.65
Skewness	0.311	0.242	1.265	0.819
Kurtosis	3.01	4.31	5.23	4.59

Correlation Matrix				
	Indexed Nominal Bond Returns	Indexed Real Bond Returns	Non-Indexed Nominal Bond returns	Non-Indexed Real Bond Returns
Indexed Nominal	1	0.90	0.52	0.34
Indexed Real		1	0.59	0.57
Non-Indexed Nominal			1	0.93
Non-Indexed Real				1

Chart 5

**Standard Deviation of overlapping annual returns on portfolios consisting of stocks and bonds: Data from 1953 to 1998**

Panel A: Nominal Returns											
% Bond	0	10	20	30	40	50	60	70	80	90	100
Non-indexed	16.7	15.2	13.7	12.3	10.9	9.6	8.4	7.4	6.6	6.1	6.0
Indexed	16.7	15.0	13.3	11.7	10.1	8.6	7.3	6.3	5.7	5.7	6.2
% Reduction	0.0	1.4	3.0	4.9	7.1	9.7	12.1	13.6	12.2	6.5	-2.7

Panel B: Real Returns											
% Bond	0	10	20	30	40	50	60	70	80	90	100
Non-indexed	16.8	15.4	14.0	12.6	11.3	10.1	9.0	8.0	7.2	6.7	6.5
Indexed	16.8	15.1	13.5	11.8	10.2	8.7	7.3	6.1	5.2	4.8	5.0
% Reduction	0.0	1.5	3.3	5.6	8.5	12.0	16.3	21.2	25.4	26.8	23.3

Variances and covariances based on monthly series of one-year historical excess returns (non-indexed bond/stock) or simulated excess returns (indexed bond) from June 1953 to December 1998.

Chart 6

**Standard deviation, Sharpe ratio, and M<sup>2</sup> of stock-bond asset allocation portfolios using real returns: Data from 1953 to 1998**

Panel A: Non-Indexed Bond											
% Bond	0	10	20	30	40	50	60	70	80	90	100
% Excess Return	6.0	5.5	5.0	4.5	4.0	3.5	3.0	2.5	2.0	1.5	1.0
% Std Deviation	16.8	15.4	14.0	12.6	11.3	10.1	9.0	8.0	7.2	6.7	6.5
Sharpe Ratio	0.36	0.36	0.36	0.36	0.35	0.35	0.33	0.31	0.28	0.22	0.15
% M <sup>2</sup>	6.0	6.0	6.0	6.0	5.9	5.8	5.6	5.3	4.7	3.8	2.6

Panel B: Indexed Bonds with No Inflation Risk Premium											
% Bond	0	10	20	30	40	50	60	70	80	90	100
% Excess Return	6.0	5.5	5.0	4.5	4.0	3.5	3.0	2.5	2.0	1.5	1.0
% Std Deviation	16.8	15.1	13.5	11.8	10.2	8.7	7.3	6.1	5.2	4.8	5.0
Sharpe Ratio	0.36	0.36	0.37	0.38	0.39	0.40	0.41	0.41	0.39	0.31	0.20
% M <sup>2</sup>	6.0	6.1	6.2	6.4	6.6	6.8	6.9	6.9	6.5	5.3	3.3

Panel C: Indexed Bonds with Inflation Risk Premium of 50bp											
% Bond	0	10	20	30	40	50	60	70	80	90	100
% Excess Return	6.0	5.5	4.9	4.4	3.8	3.3	2.7	2.2	1.6	1.1	0.5
% Std Deviation	16.8	15.1	13.5	11.8	10.2	8.7	7.3	6.1	5.2	4.8	5.0
Sharpe Ratio	0.36	0.36	0.36	0.37	0.37	0.37	0.37	0.35	0.31	0.22	0.10
% M <sup>2</sup>	6.0	6.1	6.1	6.2	6.2	6.3	6.2	5.9	5.2	3.7	1.7

Variances and covariances are based on monthly series of one-year historical excess returns (non-indexed bond/stock) or simulated excess returns (indexed bond) from June 1953 to December 1998. Real riskless rate is simulated.

**TIPS****The total return derby**

For all the reasons we've outlined in past issues, TIPS continue to represent an outstanding investment. Anyone still not convinced of the merits of these inflation-linked instruments (possibly brainwashed by official pronouncements that infla-

tion is dead), should check Chart 7.

While past history does not guarantee future results, the logic that propelled these instruments to the top of the list should continue to do so for the indefinite future.

Chart 7 – TIPS vs. Treasuries

Index	6 months	1 year	3 years	Annualized
Barclays Capital US TIPS	7.496%	8.851%	32.048%	9.709%
Merrill Lynch US Treasury Master	3.566%	8.412%	25.370%	7.828%
Merrill Lynch US Treasury 10 yr. +	4.222%	9.141%	27.572%	8.456%
Merrill Lynch US Corporate Master	1.986%	7.080%	23.675%	7.340%
Merrill Lynch US Corporate Long Term	0.547%	6.296%	21.935%	6.834%
Merrill Lynch High Yield	-5.366%	-4.364%	-6.166%	-2.099%
Merrill Lynch Global Emerging Market	0.615%	-3.917%	23.133%	7.183%
Barclays Capital French TIPS	4.321%	7.591%	11.923%	3.826%
Barclays Capital Canadian TIPS	8.813%	7.005%	31.707%	9.615%
Barclays Capital UK TIPS	4.590%	6.890%	10.787%	3.474%

All results as of June 30, 2002

**CORPORATE SPOTLIGHT**

## Painful silence: Are A&P investors justified in suspecting the worst?

By Yakov Friedman

Corporate America certainly has had its share of fiascos: Enron, Kmart, WorldCom, and the list goes on. But large corporations don't have a monopoly on questionable management maneuvers. Smaller companies, though less noticeable, surely have their share of tales. Even though there might not be outright fraud, the actions taken by management often leave one wondering.

A case in point might be the Great Atlantic and Pacific Tea Company. While the story is still playing itself out, the events to this point in time speak for themselves. The accounting issues, personnel turnover, and lack of transparency all are indicative of a company that has serious issues. The response of the analysts and rating agencies to the twists and turns in the saga also leaves a great deal to be desired.

A&P, as it is commonly known, was once a food retailing giant with over 15,000 locations across the continent. Today, after many years of changes, the store base is barely 700. But the tale here is not about the ancient history. It is about the day-

to-day developments as the company once again tries to reposition itself in the highly competitive grocery business. With local rivals in a promotional mode and Walmart making inroads into classic grocers' territories, a change of direction certainly is needed. What has been done to date and the way it has been carried out make for an interesting read.

### One-time costs and other accounting issues

In March 2000, the company announced a four-year \$250 million supply-chain initiative. The focus of the plan was to "develop a state-of-the-art supply-chain and business-management infrastructure." The forecast called for \$325 million of cash benefits over the four years from improved margins, increased sales, and a continuing boost to the bottom line of over \$100 million per year after the conclusion of the program. A quarter-billion-dollar price tag was quite hefty for a strategic initiative, but the promised payoff was the light at the end of the tunnel.

While the operating earnings showed some improvement, the expenditures on these initiatives and other "one-time" restructuring costs forced A&P to post absolute losses for six consecutive quarters. Each press release would celebrate an improved top line (always a good indication of a company's success) and would include two sets of numbers. Those presented "as reported" as well as "pro forma" numbers, which would ignore the "strategic" expenses. Then the company began to add a third set of figures, which accounted for strategic store closings. As if that weren't enough, a table was thrown in to show earnings with and without "one-time" early debt retirement cost. All this amounted to pages and pages of different sets of results for the same entity.

Just when it seemed that the consecutive loss streak would be headed for seven, the management reached into its hat and pulled out a \$60 million cash inflow from the demutualization of a life insurance company – in time to include it in the year-end financial statements. Of course, that meant yet another table showing the differences between including and not including this item. Although this was clearly recorded as a one-time event, the bottom-line earnings including all one-time costs now included a one-time income and no longer appeared to be so bad. Intentional or not, it sure was a clever idea.

While one could perceive this as a wonderful amount of disclosure, it could equally be seen as a confusing wad of numbers, with enough twists to give anyone a headache. To someone skimming over the headlines, it would be easy to come away with the impression that this was a company on good footing with a few one-time costs that should be dismissed. Bloomberg, for example, presented the earnings for the company on a "before-exceptional-cost" basis. This practice led to uncertainty as to which of the group of "one-time costs" would and should have been included each quarter. Indeed, the data provider has recently restated the reported earnings to include some more of the charges.

The real issue seems to be how "extraordinary" these "extraordinary" costs really are. Everyone understands that there inevitably will be charges for all companies that are not recurring and don't truly reflect a firm's performance, justifying omitting them from normalized earnings. This company's pattern of charges makes one wonder whether such options in accounting may be abused. As previously mentioned, the strategic initiative was unveiled in March 2000 as a four-year, \$250 million program. This was not its real beginning. In fact, the company had first announced its original list of strategic initiatives in December 1998 and had just completed that round of charges in Feb. 2000, immediately before beginning "Project Great Renewal Phase 2."

This was not the only case of ongoing one-time costs. In September '99 the company claimed it was "completing the

exit program for underperforming stores." Subsequently, it announced in November 2001 a new \$120 million charge to close underperforming stores. In light of the continuing appearance of these charges on the books, one would not have to go too far out on a limb to predict that as soon as Phase 2 of the "Great Renewal" is complete, "Great Renewal Phase 3" will begin. The appropriateness of accounting for these expenses as one-time events is certainly questionable.

Let's put it into perspective. Over the last 14 quarters, charges, including store closing expenses, have totaled over \$10 per share (or almost \$400 million!!) compared with earnings from operations totaling less than \$5 per share. According to the original plan, the "Phase 2" initiative's costs were supposed to be offset by benefits to the bottom line that were to take effect this past fiscal year. Instead, \$1.40 per share was charged to the program over the year while overall operating income excluding these charges was only \$1.44 per share (before restatements – see below), providing a net profit of less than a nickel a share.

While A&P's original projections in March 2000 called for a significant positive net impact on ongoing operations earnings beginning in 2002, the company is currently projected to earn only 85¢ net of these "one-time" costs in fiscal 2002. The company has not let on that the initiatives are not producing the desired results.

Like many corporations, clever accounting techniques have been used to improve results. Among them, book gains, which resulted from sale-leaseback transactions, are amortized over the lease lives, thus producing an "artificial" reduction in rent expense and increased reported earnings from operations. Operating leases with long-term commitments totaling over \$3 billion are held off the balance sheet and included only as a footnote to the financial statement.

Also, the company, like so many others, hides the expense of option-granting to employees in the notes to its annual report. The recently filed 10K disclosed that in the last fiscal year, EPS was inflated by 12¢ because of the non-reporting of option-granting expense. This follows amounts of 11¢ and 7¢ in the two previous years. That's quite a nice bonus for management that netted their shareholders a loss of \$2.02 per share over the three years. (And that's before including the hidden 30¢-per-share option-granting cost over the period.)

### **Management turnover**

A top analyst recently labeled the A&P story a thorough turnaround. Perhaps she was referring to the turnaround in management. Sure, a good shakeup of management is often just what is needed to put a struggling company back on its feet. In this case, things may have been taken a bit too far. While one would expect to see a new or modified management team in place before a turnaround was attempted, the musical-chair games

games that have taken place in A&P's management after the commencement of the project leave one wondering.

The executive who directed the upgrading of the IT system and was celebrated by the company when he joined, suddenly left the company in February, just as the undertaking was supposed to start showing results. He was preceded by the departure of one of his top officers, the Vice President of Information Technology. The *Newark Star Ledger*, a newspaper local to the company's headquarters, tried to have the company comment on the significance of such an important player leaving the firm midway through a project which he had described to an IT magazine in an interview as a "bet the company" gamble. The newspaper's phone calls were reportedly not returned.

Additionally, the Atlantic division, its largest, has seen the departure of two presidents in the past year. On top of this, the VP of merchandising and the COO both left in 2000, and the CFO left earlier this year. The CEO was recently named as the Co-CEO of the controlling Tengelmann Group. The company has yet to comment on how this will affect his ability to actively manage A&P.

The lack of comment is not an isolated incident. Investors had to rely on the local press to read of the company's very recent shuffling of four division heads and the departure of several senior managers. The company issued a statement that referred to only one of the moves and declined comment on the rest. Internal memos obtained by the local newspaper were the only source of information regarding the executive shift. While some small-firm analysts expressed concern over these goings on, the larger houses have been slow to react. The analysts appear to be burying their heads in the sand.

### Disclosure

The company's disingenuousness is appalling. SEC regulations require all listed companies to file their yearly report within 90 days of their fiscal year-end. On May 24 this year, precisely 90 days from the conclusion of the fiscal year (and after the close of the market to boot), A&P requested from the SEC a 15-day delay in which to submit its annual report. The company cited an issue of vendor allowance recognition – the same matter that played a significant role in the decline of Kmart just a short while ago. The company had no further comment, and the two-week waiting period began. The due date came and went, and no filing took place. A strange silence ensued.

As the ordeal continued, nervous investors began to dump their stock. Despite the filing of seven class-action lawsuits, the policy of silence continued. Even after a competitor issued a profit warning and other rivals issued statements reconfirming or modifying expected earnings, A&P maintained its silence. Finally, over a week after the extended deadline, a

press release promised a filing of the 10K by July 3. Again, the day came and passed. No announcement was issued.

Even as the saga dragged on, the Standard & Poor's ratings agency reaffirmed its ratings of the company's bonds. In doing so it cited strong market share figures, which exactly matched claims made in the company's own press release of June 2000.

At 5:00 a.m. on July 5, after *The New York Times* had already printed a story of the news of the latest missed deadline, the company announced that it was ready to file. It acknowledged that improperly recorded vendor allowances and inventory overstatements caused income to be overstated by more than \$10 million during the past three years (when reported net income was already heavily negative). This came as a relief to one big-firm analyst who referred to it as "a minor amount of fraud." If such violations of a company's policy can go undetected for such a long period of time, has management totally lost its grip on the company?

There is little doubt that the massive management shift mentioned earlier came in response to the company's findings in its audit. Still, the company continues to stonewall its investors. Virtually no explanation was given to the fact that the total sales had dropped from the same quarter one year earlier, and same-store sales had grown only a minuscule 0.2%. Amazingly, some analysts reaffirmed their (strong) "buy" rating despite the fact that in previous quarters, the company had prided itself on rising sales.

But the revelations did not stop there. During the audit of the previous year's books, the company decided that it should retroactively change accounting policies. Magically, what would have been a \$10 million charge turned into a \$40 million earnings bonanza over the three restated years. The restatements took \$37 million off retained earnings, but apparently that was a result of charges to periods before the three years of restatements that were provided by the company. The rewriting of the books also presented the company with some unrecognized revenue that would be made available to improve the bottom line in the coming years. The fraud that was uncovered turned, in the hand of sagacious accountants, into a blessing in disguise.

After so much tight-lipped behavior by management, it was a welcome relief to see that the company had scheduled a conference call to take place two days later. (The company decided that the day of the critical press release was a good day to shut down operations and take a well-deserved long weekend while investors mulled over the numbers.) Not surprisingly, the call would be held at the exact same time as Safeway's, whose previously announced earnings call was receiving much attention.

When the analysts were allowed to pose questions, it was no surprise that several who regularly covered the company had someone else filling in for them to query the management.

(All the analysts listed by Bloomberg as following A&P follow Safeway as well.) Perhaps that would explain why the call lacked the tough, probing questions one would expect after the absurd sequence of events of the past few weeks. No one wondered why the company had nothing to say all along to alleviate investors' fears. No one probed the appropriateness of the announcement of new accounting policies in conjunction with the earnings restatements.

The disclosure by the company that the turnaround had a long way to go and that competition was strengthening didn't seem to deter the analysts. The company's generic claim that it had its "own game plan" seems to be enough of an explanation to put nerves at ease.

And the saga continues. With no guidance expected from the company before its July 29 earnings release and its July 30 annual meeting (delayed because of the delayed filing), the

guessing game goes on.

While this is only one example in the universe of investments, it should bring home a disturbing trend in the community. Investors are feeling increased frustration as they get the feeling that investing in supposedly reputable companies is turning into more of a crapshoot than making an honest bet on a transparent firm. It's one thing to countenance that earnings multiples are absurdly high. It's a totally another thing when the earnings don't even exist and management is less than open in facing up to its problems.

*Disclosure: Our firm's hedge funds took a short position in the company in early May 2002. The position was subsequently increased on July 9, 2002.*

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## **JAPAN**

# **Dogs and demons: A revisionist tells tales of Japan**

*By Vincent DeCaën*

*"In the ancient Chinese philosophical treatise Han Feizi, the emperor asked a painter, 'What are the hardest and easiest things to depict?' The artist replied, 'Dogs and horses are difficult, demons and goblins are easy.' By that, he meant that simple, unobtrusive things in our immediate environment – like dogs and horses – are hard to get right, while anyone can draw an eye-catching monster. Japan suffers from a severe case of 'dogs and demons.' In field after field, the bureaucracy dreams up lavish monuments rather than attend to long-term underlying problems ..."*

Try to imagine, if you will, the introduction of strict gun control legislation in the United States. Just trying to imagine Americans rising above their antiquated frontier mentality is difficult. Or try to imagine women-priests in the Catholic Church, preaching birth control. Or Britain without a monarch. Why is such change so hard to imagine?

This note asks, can Japan change in its hour of crisis?

*"Seeking to reform the gigantic structure of the bureaucracy is a project overwhelming in its scale, involving nothing less than a radical change in social mores; the entire country would be turned upside down and inside out. That is exactly what Japan's leaders dread: They fear that if they make too many changes, the whole jerry-built edifice of bureaucratic management will collapse, and the nation will sink into anarchy."*

How many times have you said, "How could I have been so blind?" Love is "blind," they say. And yet, "truth hurts." Defying reality has painful, often dangerous, consequences.

We seem endlessly capable of weaving webs of denial and deceit. We see what we want to see; we believe what we want to believe. But sooner more often than later, we hit that hard wall of reality. The spell is broken, the veil is lifted. And then we find that truth really does hurt.

*"Against the dissatisfaction felt by the public is arrayed a complex system of bureaucratic control, infinitely more subtle than anything ever achieved in Russia or China in their Communist heydays."*

No one thanks the whistle-blowers. Among academics, such whistle-blowers who expose nationalist mythologies and related nonsense are branded "revisionists." Revisionist studies have popped up like wildflowers after a desert rain in one field of studies after another.

In Japanese Studies, apparently blinded by romanticism and nostalgia (and perhaps Cold War considerations?), one revisionist study that deserves serious attention is Alex Kerr's *Dogs and Demons: Tales from the Dark Side of Japan* (New York, 2001), the sequel to his *Lost Japan*. This note offers a review of the book concentrating on international finance.

*"How Japan went bonk – falling so quickly from being the economic and cultural darling of the 1980s into a profoundly troubled state in the 1990s – is one of the strange and terrible tales of the late twentieth century."*

Kerr treats the many facets of the Japanese malaise within the framework of a "profound cultural crisis" stemming from 1868 and the Meiji Reforms. The Meiji slogan, *wakon yosai*, "Japanese spirit, Western technology," summarizes the funda-

mental problem. An imperialist feudalism failed to modernize, rejected change outright, erected towering bureaucratic pyramids to prevent change at all costs. Hence, the contradiction of “a postindustrial country with preindustrial goals.”

*“These things point to something much deeper than a mere period of economic decline; they represent a profound cultural crisis, trouble eating away at the nation’s very soul.”*

To understand this malaise, then, we must study how *wakon* is combined with *yosai*. We have already seen the consequences of massive bureaucracies force-marching peasant societies to the promised land of industrial growth – such is the legacy of Stalin and Mao. To this, we must add a deeper knowledge of the extremism of *bushido* (the ancient warrior code) and the chauvinism of *shinto* (the indigenous mythology of Japan).

*“Japan’s financial system rests on bureaucratic fiat, not on something that has intrinsic value. ... It was a powerhouse, but it also was a Ponzi scheme. Ponzi schemes work well as long as money keeps flowing in; when the flow stops or slows down, trouble ensues. During the period of high growth... Japan’s financial system seemed invincible. ... When, in the early 1990s, it slowed to 1 percent or less, the system began to fall apart.”*

Recall that the S&L fiasco represented 2.7% of American GNP. In comparison, the Japanese financial crisis would ring in close to 10 times that, at 23% of GNP – “a crushing burden.” The source of the problem is an aggressive bean-counting known as “book value accounting.” All assets are valued at the purchase price, not the current market price. National policy is to prop up all prices, especially land, at all costs. As a result, the balance books of Japanese banks are complete fictions. Indeed, with a Moody’s rating of E+ or worse, the Japanese financial institutions are essentially bankrupt. In this astounding Ponzi scheme, no bank can fail, no investor can lose, no debt is paid, and stocks trade above 100 times earnings.

*“With a twist: In banking fiascos elsewhere, banks typically go under; in Japan, with a few exceptions, the government cannot allow that – so the nation has paid the price in other ways.”*

The only result must be paralysis, because these artificial values are stacked like a house of cards, each propping the others up. “The problem is that Japan’s banks and securities firms rely for their very life on unreal values” – they are “hooked on the narcotics of these unreal values.”

*“Today, the Ministry of Finance cannot find its way out of the labyrinth it created when it encouraged banks and securities firms to cook their books, bribe regulators, and consort with gangsters. It is lost in its own shell game.”*

What then can we expect from the financial institutions? Kerr suggests the scenario of the carnival game “Whack-a-Mole.” Every time they hammer down a problem, another pops up in another place, faster and faster. To save the banks,

the central government has to manipulate stock prices by ordering pension funds and insurance companies to bid up valueless shares. In buying useless shares, the funds bankrupt themselves. But if the government were to rationalize the stock market to save the funds, then the banks couldn’t pretend to be solvent. And so it goes, around and around.

*“Instituting a real Big Bang is simply out of the question, for the whole edifice of Japanese finance might crumble if MOF allowed economic rationalism to infiltrate.”*

Japan is effectively a one-party state in which democracy is irrelevant and the judiciary is not at all independent. The media are closely controlled and produce *Pravda*-like propaganda. What would one expect from a system that puts the old USSR to shame? What happens to a nation that adopts “an extreme form of bureaucratic rule”?

It doesn’t take much imagination to suspect that the endgame is bribery, wining and dining, structural corruption. But the Japanese system beggars the imagination. “Officials have devised many ingenious ways of channeling funds into their own pockets.” The ultimate pork barrel – “Boondoggle fever is infectious.”

Where does the money come from? The bureaucracy, it turns out, has its own “private piggy bank”! The enormous deposits in Japanese postal-savings accounts – “an inexhaustible pool of public savings” – are handed over to the Ministry of Finance to “manage,” thence flowing invisibly off the books into every scheme imaginable. “No force on earth can stop the forward march of Japan’s bureaucracy, for the simple reason that there is ample money to support it.”

(The real debt of Japan thus could be as much as 150% of GNP when the second shadowy budget is factored in.)

*“In Japan’s case, unlike that of the sorcerer’s apprentice, there is no wizard who knows the charm that will stop the brooms.”*

Japan is *doken kokka* – the Construction State, an interesting if environmentally devastating approach to the make-work social-welfare state. These are not real jobs: roads and railways to nowhere; art museums that cannot afford artworks; unneeded dams; concrete-armored seacoasts; stripping native forest cover in favor of commercial *sugi* (Japanese cedar); and so on. In such crony capitalism, handouts flow to politicians, civil servants, and company management at all levels. It is not exaggerating to talk in terms of “drugs” and “addiction” and “severe withdrawal symptoms.”

Surprisingly, consumer credit lies outside the bureaucratic system. Individuals are punished by usurious interest rates of up to 40% (while corporations borrow at effectively 0%!). The actual rate is as much as 100%. Millions are drowning in debts to the gangsters that run the “consumer loan companies.” The response is *yonige*, the midnight run of tens of thousands every year, facilitated by agents known as *benriyasans*, “Mr. Convenient.”

*"A system that favors gangster-ridden loan sharks as the established means of consumer credit, allows banks and insurance companies to practice financial scams with impunity, rewards savers with near-zero interest rates, and punishes debtors with interest rates of 40 percent and higher – it doesn't take an expert economist to predict what this will do to public savings over time."*

As prognosis, Kerr offers two metaphors.

The one is that the entire nation has been turned into a titanic industrial battleship, but there is no one at the con. "There is no pilot, nobody who can throw the engines into reverse once the ship of state is under way; and so it moves faster and faster until it crashes onto the rocks. ... "Nobody can slow her as she steams full speed ahead toward a colossal shipwreck."

*"The figures for debt, bad loans, failed stock markets, and so forth are staggering enough to keep the leaders of most other countries lying awake at night in terror. Yet Japan's government agencies seem curiously unconcerned."*

A frog will hop out of a pot of boiling water. But turn up the heat slowly instead, and that poor frog will die at a slow boil. Japan is that poor frog. "Radical change will come only when conditions have grown completely intolerable, and in Japan's case that day may never come."

*"The country is eating into its savings – of this there is no doubt. But for the time being there are still trillions of dollars*

*of assets in savings, much of it deposited in the postal-savings system ... . Stagnation is most likely in the absence of a major shock to the system, such as a wholesale economic crash ... . Sadly for Japan, a crash is highly unlikely. The chances are that for the next decade or two there will never come a moment when the nation stares disaster right in the face."*

Can Japan change? Or will the frog gently come to a boil in a pot of slow growth, increasing unemployment, and mounting debt burdens supporting the Construction State? Or will Japan turn in on itself, slam its doors closed, fire its foreigners, indulge in nostalgia, return to a reactionary nationalism of the darkest hue? For opposition to globalization is steadily gaining momentum in Japan, opposition to liberalism and liberalization, and populist dreams of a new *shogun* (generalissimo) who will lead Japan back to the Eden of Edo are returning.

**Appendix: Numbers to Numb**

Pension liabilities at 100% of GNP (estimated 1997)

US corporate debt-to-equity: 1.5/1

Japanese corporate debt-to-equity: 4/1

Bad loans written off by banks, to date: maybe 20%

US P/E ratio: ~ 30 (Dow Jones, early 2000)

Japanese P/E: 106.5 (Nikkei, 1999)

Capital-to-asset ratio demanded by BIS: 8%

Estimated real ratio for Japanese banks: 2%-3%

Real government debt: Possibly \$11 trillion = 250% of GNP

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