

FRIEDBERG'S

COMMODITY & CURRENCY COMMENTS

Friedberg Commodity Management Inc.



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The backbone of every investment strategy

Let's talk about inflation-indexed Treasuries, commonly called TIPS.

We can't help but believe that world economic growth will slowly grind to a halt, brought about by wasteful (in economic terms, of course) war mega-spending, war-related interdiction of shipping and trade routes, war- and terrorism-related consumer caution, and bubble-induced overcapacity.

As if all this weren't enough, consider rising unemployment in the G10, some of it due almost entirely to rigid and antiquated labor laws (Euroland), some of it to severe deflationary pressures that raise real wages (Japan), some of it to continuing pressures on profit margins (US).

In macroeconomic terms, the inevitable rise in the US savings rate should guarantee below-potential rates of growth in the US and the nearly certain rise in unemployment over the coming quarters and years. As well, Japan's economic juggernaut faces a severe contraction in the not too distant future, at least in its initial stages. Finally, redressing the various ECB members' fiscal overshooting of the 3% target deficit implies lower spending – or, more likely, higher taxes – and more downward economic pressures.

What does zero, or rather declining per capita, economic growth spell? Lower investment opportunities and therefore lower real rates of interest. Since every *nominal* bond has two components, a real interest rate coupon and a premium to compensate the holder for future loss of purchasing power, we can be sure that at least one of these two components will shrink in coming months and thus give bonds a price lift.

The problem resides in the second component: Will inflationary expectations rise or fall in coming months? Or more precisely, will inflationary expectations rise above or fall below the presently embedded premium (the so called breakeven), now at 235 basis points for the 2028 maturity (see Chart 3)? If these expectations rise, then interest rates, the combination of real rates and a premium for inflationary expectations, may rise – that is, if the expectations component rises faster than the fall in the real rate. If they rise but don't rise faster than the decline in real rates, they may still blunt the beneficial effects of a drop in the real rate of interest.

Of course, if inflationary expectations fall, then the bondholder enjoys the double whammy of falling real rates of interest and falling inflationary expectations. Since inflationary expectations are difficult to fathom (there are good arguments for those who expect lower inflation and for those who

expect higher inflation – we tend to the latter), we want to avoid making such a bet. We therefore avoid nominal bonds.

Instead, we prefer to bet solely on the course of real rates, which, as explained earlier, we comfortably believe are headed lower. The added bonus: For some inexplicable reason (cognitive dissonance, the wish for such an event?), the market has continuously underestimated the actual inflation numbers. This has caused TIPS holders (and especially the Canadian ones) to earn, on a static basis, consistently more than holders of the equivalent maturity nominal bonds. That is, the actual inflation number exceeds the built-in premium by anywhere between 50 and 300 basis points, a very sizeable bonus in this age of super-low nominal returns.

In sum, we take the view that actual inflation will exceed embedded expectations if only because the market has ignored – for intellectual and emotional reasons – the potential effects of the Fed's extraordinarily expansive monetary policy. At best, we earn more than nominal bonds. At worst, actual inflation turns out exactly as expected (and as indicated by the breakeven, see again Chart 3), and we earn the same total returns as those who hold nominal bonds. This, in short, is our essential argument for buying and holding TIPS.

Finally, a word about credit quality. In recent weeks, there has been a sustained rally in high-yield and other lesser-rated bonds, including emerging market debt, on the back of improving default rates and generally falling risk-aversion (see Chart 4). On the other hand (aside from the fact that default rates have temporarily fallen simply because we have gone through most of the newer vintage crop, issued during

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Contributions by Albert D. Friedberg, Jeremy Fand, Yakov Friedman, and Vincent DeCaen.

Futures and options trading is speculative and involves risk of loss. Past trading results are not indicative of future profits.

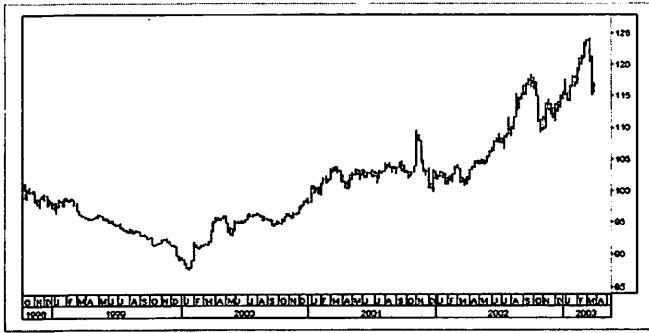
the boom years 1996-2000), fundamentals have changed little if at all.

Cash-flow generation for the US corporate sector is once again falling below capital replacement and dividend requirements. Emerging countries, especially Brazil, continue to experience rising debt/income ratios. Old Economy corporations, here and abroad, continue to experience rising pension

obligations, consumer debt is just beginning to wilt despite the lowest interest rates in a generation. (See Chart 5, MBNA Corp., and Chart 6, Capital One Financial Corp., for a graphic illustration.)

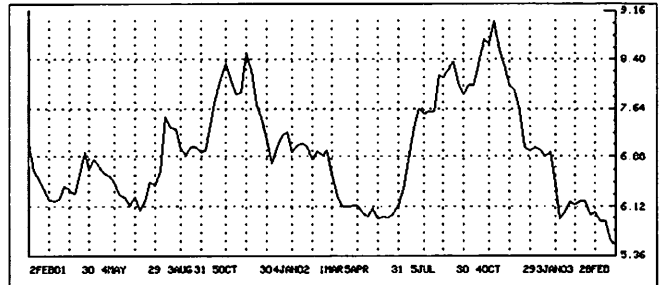
In short, an overindebted world has made little or no progress in improving creditworthiness. In this kind of world, why own anything other than triple-A government securities?

Chart 1 – US TIPS 3.625%, 15 April 2028



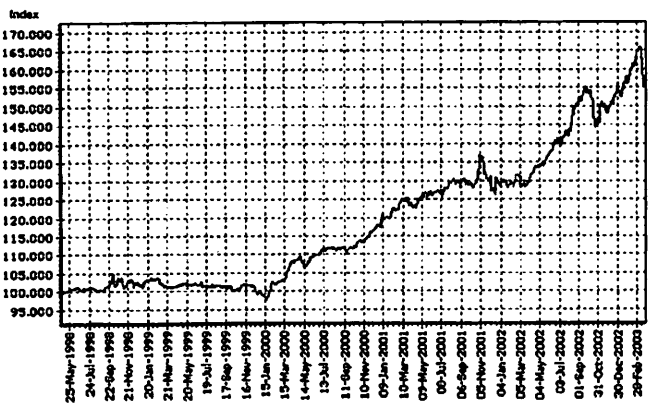
Courtesy Bloomberg LP

Chart 4 – Merrill Lynch global bond indices, Spread of yield to maturity: Global High Yield and Emerging Markets* minus 30-yr. US Treasury



Courtesy Bloomberg LP

Chart 2 – Total Return TIPS 2028

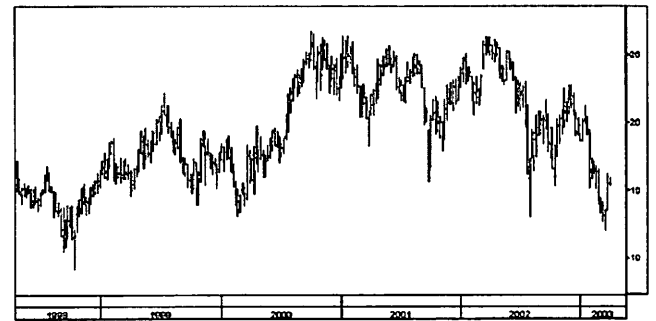


Courtesy Barclays Bank PLC

* Equivalent to 57% cumulative return for the period

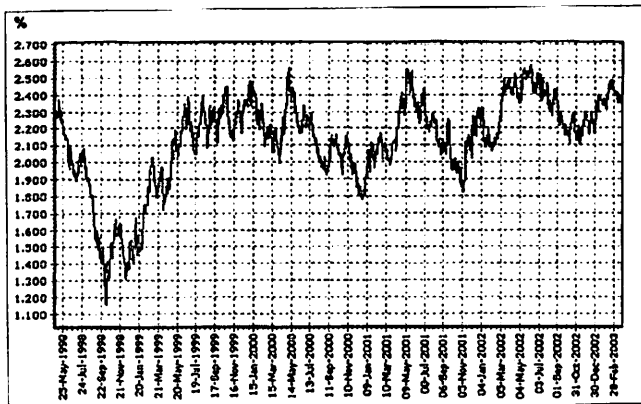
Chart 5 – MNBA Corp.

MBNA Corporation is the holding company for MBNA America Bank, N.A. The Bank issues credit cards, marketed primarily to members of associations and customers of financial institutions. MBNA also provides retail deposit, consumer loan, and insurance products, as well as credit card, consumer loan, retail deposit, travel, and shopping services through its Web site.



Courtesy Bloomberg LP

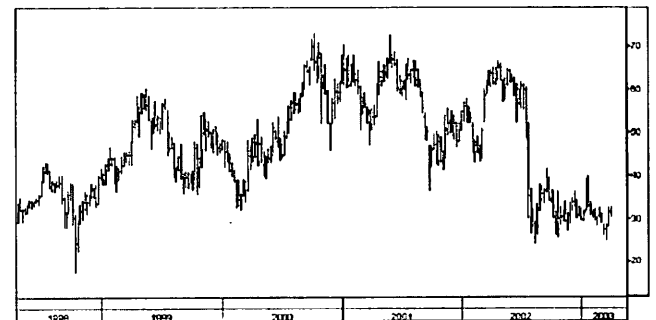
Chart 3 – Breakeven US TIPS 3.625%, 15 April 2028



Courtesy Barclays Bank PLC

Chart 6 – Capital One Financial Corp.

Capital One Financial Corporation provides a variety of products and services to consumers through its subsidiaries. The Company, through Capital One Bank, offers credit card products. Capital One F.S.B. provides certain consumer lending and deposit services. Capital One Services, Inc. provides operating, administration, and other services to the Corporation.



Courtesy Bloomberg LP

FOREX**The Swiss franc dilemma***By Jeremy Fand*

As fear of terrorism and economic recession has gripped the world, the Swiss franc has found itself in favor against both the US dollar and the euro. This comes despite a weak domestic economy and exceedingly low interest rates. The Swiss National Bank (SNB) has not only been aggressive in lowering interest rates to try to boost the economy, but it has also explicitly been trying to weaken the currency. While the start of the Iraq war has caused a bit of a setback in the strength of the franc, the SNB seems eager to see the franc weaken further.

Geo-political concerns drive investors into the old safe haven

The Swiss franc is a traditional safe haven currency. In the late '90s, when equities were on fire and risk-taking was abundant, the Swiss franc was very weak. But as the stock market bubble burst and economic malaise set in, the franc started to regain ground against the US dollar and the euro.

The euro/Swiss franc cross sat comfortably stable in the 1.50 to 1.55 range in the year before the Sept. 11 terrorist attacks. As can be seen in Chart 7, the risk-aversion that the terrorism created caused the franc to strengthen into a new range against the euro. While the cross rate has been in a relatively stable range of 1.45 to 1.48 since those events, the rate is attempting to break higher as official discomfort with persistent franc strength and declining risk-aversion is weakening the currency.

Weak domestic economy weighs on the franc

Switzerland's economy is suffering despite aggressive interest rate cuts by the Swiss National Bank. GDP grew at a 1.4% annualized rate in the fourth quarter of 2002, falling from a 1.7% growth rate in the third quarter. Consumer spending appears to be slowing this year as existing overcapacities of companies and a weak labor market constrain spending.

The Swiss Purchasing Manager's Index (PMI) for February posted weaker than expected at 48.0. This weakness is paralleled in the recent KOF surveys that show growth is unlikely to accelerate any time soon. As Chart 8 shows, the Swiss economy has been lagging both the US and Europe for some time. Yet despite this negative growth differential, the currency has been strong.

Monetary policy has been the main focus of attention in recent months as the SNB has been desperate to stimulate the economy and weaken the currency. Indeed, monetary policy is the only tool to fight these battles, because fiscal policy is being constrained. Parliament has asked the finance minister to halt real expenditure over the next few years in addition to reducing the national debt. With monetary policy the chosen tool, rates have been pushed down to near zero percent. Real rates are already negative, because

LIBOR has been pushed down to 0.25%.

Attempting to talk down the currency

While the economy is the focus of aggressive rate cutting, the currency has also been targeted. SNB officials have been quite public about their concern with the strength of the franc. They highlight that the weakness of the economy is exacerbated by the strength of the currency and have gone as far as openly discussing intervention to reverse franc strength.

In a recent speech, SNB Vice Chairman Gehrig admitted that a further rise in the safe-haven Swiss currency could not be ruled out in an environment marked by economic and political uncertainty – especially given the war in Iraq. He said that “our traditional monetary policy instrument is exhausted....Given that we no longer have any significant room for maneuver on interest rates, we will, if necessary, intervene in currency markets in order to counter an unwanted rise. It is a measure which has undesired side effects but which should never be ruled out.”

Similarly, SNB Chief Economist Kohli recently said that the central bank won't rule out intervention, although it is “a tough weapon that would be used only in a considered manner and not too often.” Interestingly, the SNB has not been clear about whether it is concerned about the franc's strength against the US dollar or the euro. Kohli suggested that US dollar/Swiss franc cross was the present concern, as euro/Swiss franc cross has at least been stable.

The Swiss have even become Japanese-like in their discussions of buying bonds as another monetary policy tool with the added benefit of weakening the currency. The Swiss Federal Treasury admits that the idea of a buyback of Swiss government bonds is “floating around, and one of these days, we may sit together (with the SNB) and discuss that matter.” This follows SNB President Roth having floated the idea of a bond buyback in the last month. The intent is to increase the supply of Swiss francs in the banking system, and hopefully ease the upward pressure on the currency.

The Swiss are likely to have little luck in manipulating the currency as they are playing with the same fire that the Japanese have been playing with for the last decade. Like Japan, Switzerland is in the tough position of having to contend with weak growth, a falling stock market, near-zero interest rates, and currency strength. The dilemma is particularly acute considering Switzerland (like Japan) is a creditor nation and has one of the strongest financial asset positions in the world.

It is no wonder that they are now bringing up the topic of intervention, because monetary policy in Switzerland seems to be as ineffective as that in Japan. Interest rate differentials should have a meaningful relationship with the currency, but that relationship is complicated by the US cutting rates at the

same time as the Swiss. As Chart 10 shows, expected interest rate differentials are basically flat and are not helping lift the US dollar/Swiss franc cross. Indeed, the strength of the franc against the US dollar in recent months has had no correlation with interest rate differentials, but has simply reflected rising risk-aversion in the run-up to the Iraq war.

Since the Iraq war began, there has been a notable reduction in risk-aversion that has helped weaken the franc against both the US dollar and the euro. While the economy continues to be weak and there is little room to maneuver on interest rates, the developments in the Iraq conflict will likely be the driver of the Swiss currency. If the news on the war is bad and risk-aversion increases, the SNB will have to step up the verbal interventions.

The challenge will be whether it actually needs to intervene. At the moment, the fate of the US dollar is far more important to the movement of the franc than any Swiss fundamentals. A significant return to US dollar selling on the back

of bad news in Iraq and a rise in risk-aversion is the biggest concern for the Swiss authorities. Longer-term, however, a US economic recovery that continues to outpace European and Swiss growth should be a catalyst to a weaker Swiss franc.

Editor's note: Building on Mr. Fand's argument, we'd like to suggest that a change in trend is actually imminent and that the overvaluation is on its way to being corrected. What caught our eye was the pronounced strength seen this week in the euro/Swiss franc rate, even as the war news was turning gloomier, a sign that perhaps the safe-haven argument was beginning to wear thin. We therefore advise buying euro/Swiss franc cross, risking a close below 1.4675. Upside potential is substantial, while waiting to realize this potential can be profitable because euro deposits yield more than Swiss ones.

Jeremy Fand writes a weekly foreign exchange comment for the research section of our Website: www.friedberg.ca.

Chart 7 – Euro/Swiss franc cross

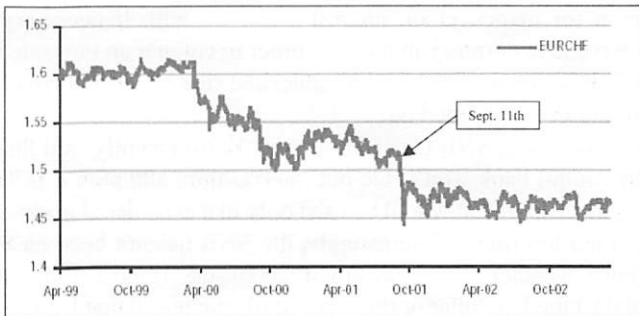


Chart 8 – GDP comparisons

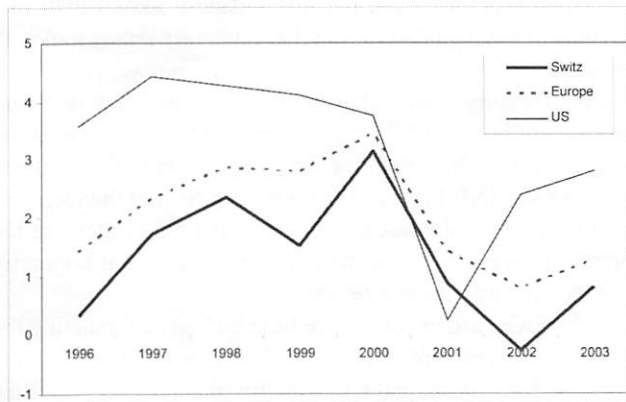


Chart 9 – Official Swiss interest rates

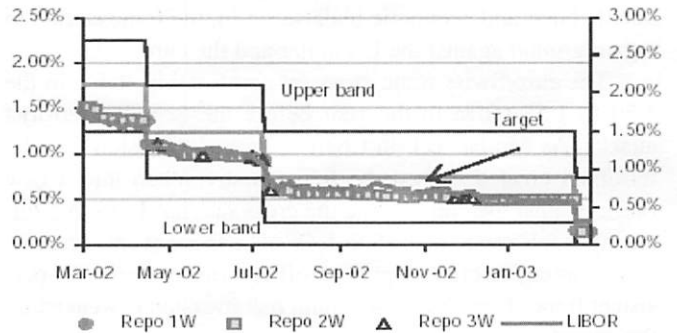
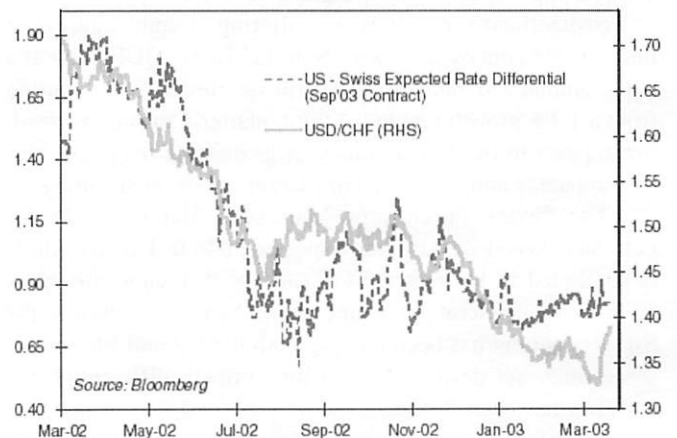


Chart 10 – USD/CHF and expected interest rates



STOCK BEAT**Volatile times call for cautious trading***By Yakov Friedman***Past Picks**

With the fluid situation in the Middle East, investing decisions have become more difficult to make. Perceived successes and failures in Iraq strongly sway market sentiment. Often, short-term euphoria encourages investors to make what appear to be irrational moves. Such an unfriendly environment makes successful investment decision-making an even more daunting task. Indeed, many investors would rather sit out the extreme volatility and wait for calmer times to return. Against this background, let's review our recent stock suggestions and offer one more.

***The Great Atlantic & Pacific Tea Company.** In our January issue, we stated that we were no longer comfortable with our short position in The Great Atlantic & Pacific Tea Company. While we have continued to see weakness in the stock's performance, its low price reduced significantly the risk/return profile of a continued long position. Announcements of further asset sales have been met with both positive and negative knee-jerk reactions in the market, and we are satisfied that we were able to ride the bulk of the decline. The bet from these levels is whether the company will enter bankruptcy before it can get its act together – a call we are not prepared to make.

***Walgreen Company.** At the same time, we advised staying short Walgreen Company. Our position ran into trouble when the market responded euphorically to initial reports of unexpectedly rapid progress by the American troops in Iraq. As expectations rose for a quick resolution to the war, investors, not wanting to miss out on the next bull market, ran to pour money into their old favorites. While the move reminded us that a bull market allows much higher earning multiples to be attached to stocks, it did not sway us from our position. Although the stock has basically treaded water relative to benchmarks since our previous update, we still see Walgreen underperforming the broader index in the weeks ahead.

We continue to concede that Walgreens appears to be a strong company that consistently grows its earnings. The valuations of the company, however, continue to be rich, especially when viewed in relation to other pharmacies (see Chart 11). Additionally, the company's recent second-quarter earnings release, while showing good results, reinforced a number of our concerns about the firm.

The policy of not offering an analyst conference call still bothers us. As well, in its brief press release, the company disclosed that the net number of stores it will open this year would be slightly below previous expectations. While this on its own is not significant, we have already noted that the company's expansion plans may be overly ambitious in the present climate. We sense that our concerns are beginning to be validated. Finally, on a technical note, the stock's persistent downtrend

has been well contained within a tight channel (see Chart 12).

Clearly, the decline in the market value of the company over the past several months coupled with progressively better earnings have made the trade less compelling. As such, we are more comfortable with a reduced exposure, though we still think that there is more room for the stock to fall.

***Frontline Ltd.** This Norwegian oil tanker company, whose stock we recommended holding on to in our January article, has resumed its impressive rise. Earnings for 2002 were announced in late February and met market expectations. Management reinstated the quarterly dividend at an initial level of 15¢ and indicated that continuing strong tanker rates will translate into higher dividend levels.

Industry-wide issues continued to work in the company's favor. Importers' bookings increased in anticipation of the Iraq war and in response to historically low inventory levels. The absence, thus far, of attacks on oil tankers has removed some of the short-term downward pressure we had seen on the market as the threat of skyrocketing insurance rates subsided.

Venezuelan output has certainly improved from the lowest levels, but different sources with their own agendas have various versions of what production really is. Based on the level of disruption that the industry suffered, we assume production will continue to be markedly below what it was before the strike. American importers have been forced to source their oil from more distant countries, adding support to the tanker market.

Ethnic fighting in Nigeria has the potential to temporarily add more bullish fundamentals in the short term as output has reportedly dropped by almost a million barrels a day – over 35% of the country's production. Faction leaders have made explicit threats to attack oil facilities if their demands for parliamentary representation are not met. A short-term disruption will be tolerated by the market and will result only in decreased demand. If, however, the fighting continues, as is often the case in that part of the world, additional oil will have to be shipped from other areas, such as the Middle East. This will add to the shipping distance and result in stronger demand for tanker hours. We are comfortable with our position, because we feel that the stock could go up another 10% to 20% before we reach fair valuation.

***Disappointment: Fresh Del Monte Produce.** We wish we were able to report favorably on our most recent pick, Fresh Del Monte Produce. Instead, the stock has sunk to 52-week lows in the face of a strong market rally. One thing is certain, though: The story seems to get more mysterious by the day.

The company's year-end results were released in early February, and the earnings once again beat the street's estimates. A drop in the company's tax rate (more of FDP's income is being earned outside the US) and a weak American dollar helped to magnify the profits. The stock started trading up by

10%, but it was immediately met with a flood of sell orders. Despite management's predictions during a conference call that 2003 earnings would be higher and that the lower tax rates were likely to be repeated in the coming year, the stock closed down over 5% on the day with extremely heavy volume.

While most analysts responded positively to the company's results, the analyst who had "preannounced" the lawsuits launched against the company found the results to be in line with her underweight recommendation on the stock. After making adjustments for such things as the change in tax rate, currency, and acquisitions, she determined that "core business" earnings were actually deteriorating. Amazingly, her estimates of 2003 earnings were the highest of all analysts covering the company. She backed up her conclusions with an analysis of the company's earnings, showing that certain products were suffering from lower pricing in some markets.

We find it difficult to justify focusing on specific products when the company's strategy has been and continues to be diversification in both product mix and market. While certain parts of the business may be going through the low part of their cycles, others are near the peaks. If anything, being able to show strong results in the face of choppy commodity markets attests to the company's success in its strategy. The euro and yen have continued to strengthen, undoubtedly continuing to assist profits this quarter.

Far more interesting, though, was the revelation that there was a strong possibility of an investigation by the US Securities and Exchange Commission. Without specifying what the investigation might be about, the threat of SEC involvement certainly did warrant her recommendation to stay on the sidelines. We were puzzled, though, as to the source of the continuing "inside" information.

The conference call itself proved to be a newsworthy item. As reported by *The Wall Street Journal*, the CEO of Fresh Del Monte took matters into his own hands when the analyst tried to ask a follow-up question. He told her that she was not covering the company objectively and that she was not welcome on the call. Then he hung up on her. Clearly taken aback, the analyst later told reporters that she was initially angry but eventually decided that the CEO's behavior validated her previous allegations of murky dealings.

The stock continued to sell off for the next month. In mid March, the same analyst released another report indicating that she had indeed received confirmation that the SEC had engaged in a probe of the company in late November (shortly after her initial revelation of a pending lawsuit against the company). The report also made certain allegations of illegal pricing practices. As in the past, the company immediately issued a press release denying any contacts with the SEC. It did not touch on the other claim. Not surprisingly, the stock continued to be sold off.

Another matter of note: The short interest in the stock spiked sharply over the past few months, to more than 13% of the float. While short interest in the overall market is high, the significant surge in the short position on the stock is quite remarkable.

Still another puzzling matter came to light in the company's filing of its annual report. In it, the company disclosed that it had not been served with papers in relation to one of the lawsuits that had been disclosed to the public months earlier. The company further disclosed that it had filed a motion with the court to have the other suit dropped.

As if the story did not have enough twists and turns, two days after the analyst made public the SEC investigation, the company announced that it was launching a lawsuit of its own. In it, Fresh Del Monte alleges that the Eastbrook Companies (the group that filed the lawsuit against FDP in Florida court) conspired to put downward pressure on the stock in a bid to extort money from the company. Although not charged, the company alleged that the well-informed analyst had (perhaps unwittingly) been used by the accused to disseminate misleading information. While the announcement did not effect a sharp turn in the momentum of the stock, it has relieved some of the downward pressure (so far!)

We find ourselves in a very atypical situation. Usually, when a company has achieved such rapid financial improvement, it trades at lofty multiples, and we are left to explain why the market is overvaluing the long-term prospects of the company. In this case, the reverse is true: We believe that the market is grossly undervaluing the company's potential.

In light of the events of the past months, we are uneasy speculating about what is happening here. In all likelihood, there is some (perhaps massive) misdeed on the part of one of the two sides. While we understand that many would have a strong aversion to participating in such a market, we still find the valuation compelling.

It is our opinion that management has much more to lose if it is indeed lying. The former chairman of the company, who is involved in bringing the legal action against Fresh Del Monte, is a former fugitive, who was extradited from Australia to Mexico to face fraud charges. The analyst may indeed be being fed information from suspect sources. We suppose that her next critique should be very telling, as she now knows that she is under scrutiny. If she still maintains her positions under the threat of legal action, we would have to strongly rethink our position.

It is hard to feign debt reduction. The company's long-term liabilities have been reduced to less than \$50 million. Even more impressive is the fact that it has managed to grow the business through acquisitions at the same time. If the stock were trading at a more reasonable level, we would have a different opinion. But at four times trailing four-quarter earnings and less than three times cash flow for the same period, even in a strongly cyclical business, the stock is trading cheaply.

Of course, at some point we might have to let the market take us out. For now, we are staying long but closely monitoring future developments. Our assumption is that buyers have been significantly scared off by all the twists and turns. We expect that if the stock can attain some stability for an extended period of time, we should see a flood of buying that should push the stock to more reasonable levels.

New recommendation

Foodland Associated Ltd. is an Australian-based company with retail operations. Its stock trades on the Australian Exchange. While at first glance, the shares seem to be trading at a fair level, we feel that several issues face the company as it expands its business.

The company owns and operates over 70 supermarkets in Australia and over 150 in New Zealand. FAL Wholesale is the sole supplier of independent grocers in Western Australia and operates three retail grocery warehouses. Its Farmers Holdings division operates 71 department stores in New Zealand, and its related Retail Finance Services division services over 500,000 accounts related to in store purchases.

The stock trades at a reasonable 17 times trailing-year earnings and at 36% of sales but at almost 20 times cash flow. Its free cash flow for the past 12 months is negative. Market-to-book ratio stands at about 2.15. It has had a strong record of dividend payments – a serious concern to shorts. But weak results in its businesses going forward could seriously crimp the company's ability to maintain past practice.

Foodland's recent purchase of Woolworth New Zealand's (not affiliated with Woolworth Australia, a major player in the Australian supermarket business) network of grocery stores has fueled its stock-price trip from AU\$8 in mid 2001 to over AU\$20 a year later. Since its peak in September, the stock has lost more than 10% of its value. While some of that may be attributable to the stronger Aussie dollar, we feel that harder times lie ahead. Its performance relative to the broader market has been relatively flat over the past six months but has been trailing off recently (Chart 13).

Our observations of the American supermarket industry over the past year and a half have showed us that contrary to popular belief (which we have seen espoused by analysts covering this stock), supermarkets can get hurt during an economic downturn. Though people must continue to eat, they can be extremely selective in choosing where to spend their limited resources. Additionally, we have seen the pressure on the grocery industry result in intense competition as each chain endeavors to maintain market share.

We admit that one cannot necessarily draw on American experience to predict what will happen in Oceania. Still, when the company's chairman discusses intense competitive reaction to some of its strategic moves, we see a yellow flag being waved. The general consensus of economists calls for a pullback in the strong pace of the Australian and New Zealand economies in the coming year. The latest consumer confidence numbers for New Zealand were at a two-and-a-half-year low, and the latest Australian survey showed the lowest level in 16 months.

The severe drought that has plagued the Land Down Under has devastated the agricultural industries. While forecasters are calling for much improved conditions, we assume that it will take some time until production returns to previous levels. We would look for consumers to be more selective with their grocery dollars and supermarkets to be

more aggressive with their promotions.

The aforementioned purchase of the New Zealand grocery stores was accomplished through the issuance of about AU\$300 million worth of new equity and a similar amount of debt. The enterprise value of the company is now over 20 times four-quarters' trailing cash flow from operations. Of course, anticipated significant improvements to profit levels from the additional stores should bring the multiples down going forward, but the numbers are very high compared with American supermarkets, trading at multiples of about 8. Of more concern, the company's intangibles, such as goodwill, make up about 30% of the balance sheet assets – a high proportion by any standard.

Walmart has not yet entered the Australian or New Zealand market, thus saving local retailers from the intense competition it has triggered in other parts of the world. If the giant chain does decide to establish a presence, it could change the face of retail in the region. One caveat: It is possible that Walmart will decide to get its feet wet by purchasing an interest in an established local retailer, as it has done in other areas, such as Germany, the UK, and Japan. If that strategy is adopted, there is the possibility that Foodland would become the target of its takeover aspirations, something that could significantly increase the value of the shares.

There already is a different type of new competition on the continent. The German chain Aldi has established a significant presence in Eastern Australia. The highly private, tightly held company has successfully grown its network of stores by offering a smaller number of items at significantly lower prices. Just 20 months after opening its first stores in New South Wales, the company has reportedly managed to capture 4% of the local market. More significantly, its emphasis on lower prices has sparked local price and marketing wars in Sidney, where it has concentrated the initial stores.

Because of Aldi's management's tight-lipped policy, it is difficult to speculate where they will expand next. Reports indicate that it initially will increase its presence up and down the Australian East Coast into Victoria and Queensland, where Foodland operates about 40 stores. One would think that it won't be long before it enters Western Australia, where Foodland has over 30 stores. Aldi has also registered its Internet domain name in New Zealand, triggering speculation that it may have its sights on the market in which Foodland now has its strongest presence.

The wholesale business that the company runs supplies all the independent grocers in Western Australia in addition to supplying many hotels, restaurants, and other institutions. As the sole supplier of these supermarkets, its position is enviable. There is a matter of concern, however. The State government is currently reviewing the laws that restrict the opening hours of major retailers. Most of the smaller stores that are supplied by Foodland are exempt from these rules because of their size. A relaxing of restrictions, which is widely expected to occur, will likely allow the major retailers to take a chunk out of the sales of their smaller competition. In turn, this is likely to eat

into Foodland's wholesale revenues. While some of the losses will likely be made up through the company's supermarkets that operate in the region, the wholesale business is more profitable for the company, and the bottom line will likely be hurt to some degree.

Our final concern relates to the consumer credit division. It is the largest non-bank provider of consumer credit in New Zealand. As we have seen with large retailers such as Sears, which have relied heavily on their proprietary credit cards, large problems can arise if and when consumers start feeling the pinch. The latest half-year financial results issued by the company indicate that the bulk of its earnings from its Farmers Department Stores came from the credit division – over 20% of its pre-tax earnings. Over AU\$280 million was receivable from its retail finance division. The comments from the company indicate that it is looking to expand the division, not cut it back. While we have as yet not seen indications that the company is running into difficulties with the division, we are wary of its increas-

ing exposure to consumer credit in the present environment.

A significant development has recently occurred. Foodland has indicated that it is looking to possibly sell its New Zealand department stores and retail finance position. If it is successful in doing so at a good level, some of our concern with the company may be eased. We feel, though, that in the course of trying to secure bids, some of the matters we have highlighted may come to light.

Many of the issues we have raised will turn heavily on the economy in that part of the world. As we mentioned at the start of the article, recent political events have overshadowed basic economic arguments. We recommend selling short Foodland at present levels, placing initial protective stop at the recent highs.

Yakov Friedman is an analyst with Friedberg Mercantile Group. Funds and affiliates managed by Friedberg Mercantile Group own and/or are short securities discussed in this article.

Chart 11 – Pharmacy comparison

Ticker	Name	P/E	Price to Sales Ratio	Price/Cash Flow	Price/EBITDA	Current Ratio
WAG	WALGREEN CO	28.47	1.01	19.24	15.98	1.75
CVS	CVS CORP	14.46	0.41	8.25	6.55	1.93
RAD	RITE AID CORP	NEGATIVE	0.08	2.55	2.76	1.86
LDG	LONGS DRUG STORES CORP	16.6	0.13	13.7	4	1.58

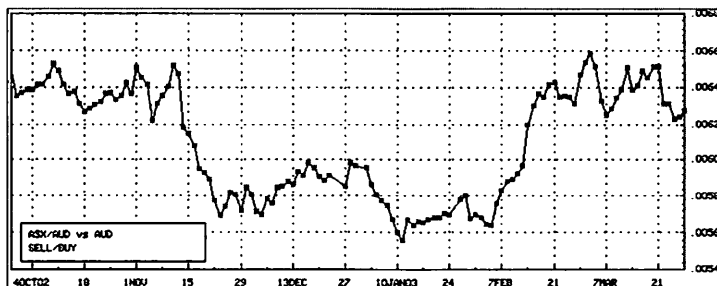
Data courtesy Bloomberg LP

Chart 12 – Walgreen Company



Courtesy Bloomberg LP

Chart 13 – Historical price ratio: Foodland Associated Ltd. v. Australian Stock Exchange



Courtesy Bloomberg LP

THE STOCK MARKET**Estimating the equity risk premium:
A longer view of the US markets**

By Vincent DeCaen

The consensus that [a normal stock market return is about 8 percent and] a normal risk premium is about 5 percent was shaped by deeply rooted naiveté in the investment community, where most participants have a career span reaching no farther back than the monumental 25-year bull market of 1975-1999.... Investors greedy enough or naive enough to expect a 5 percent risk premium and to substantially overweight equities accordingly may well be doomed to deep disappointments in the future as the realized risk premium falls far below this inflated expectation.

1. Stock returns (or lack thereof)

My alma mater, the University of Toronto, recently revealed that its much-touted money manager, Don Lindsey, lost \$400 million in the markets. The University of Toronto Asset Management Corp. (UTAM), whose creation Lindsey spearheaded, is responsible for almost \$4 billion in endowments and pension funds. While his annual compensation was just shy of the university president's, Lindsey still could not avoid the bear's claws.

UTAM's loss is not isolated. Across the country, universities, hospitals, charities, and foundations generally are facing difficult decisions in the face of increasingly "poor" returns. Some foundations have experienced their worst returns yet. Their expectations are for even worse.

Individual investors are also experiencing the bear's claws. *The Toronto Star's* "Smart Money" (sic) section reported on the first annual decline (8.2%) in mutual fund net assets in 13 years (2/20/2003, H1). "[T]he paucity of winners coupled with the stock market doldrums has put Canada's mutual fund industry into shrinkage mode." (Net sales, incidentally, already topped out in 1997.)

The headline of a further article coldly states, "Investors lower their expectations" (H3). "Many people would be satisfied with returns of 5% or 6% this year." However, the article cites a recent survey by the Toronto-Dominion Bank that indicates Canadians are *expecting* an average of 8.9%. (Just by way of comparison, the S&P/TSX Composite Index lost 13.9% last year.)

But where does this expectation of 8.9% real stock returns come from? Or, for that matter, the diminished expectations of 5% or 6%? Robert Arnott¹ and Peter Bernstein, in their recent paper, "What Risk Premium Is 'Normal?'," appearing in the March/April 2002 issue of *Financial Analysts Journal* (58.2: 64-85), address this and related questions. This note summarizes their important study.

2. What is the "equity risk premium"?

By the term "market risk premium" or "equity risk premium" (or simply "equity premium"), we understand the difference between *expected real returns* on stocks and *expected real returns* on riskless assets (say, government bonds). There is a simple formula that permits us to calculate the equity premium for any given point in time as well as the average premium for any given interval.²

Note carefully that this *prospective* measure of "equity premium" should never be confused with the *retrospective* measure of "excess returns," the actual returns *after the fact*. Thus there is a crucial distinction to be drawn between *expected real returns vs. realized returns*, even though "premium" is often applied, unfortunately, to both (p. 64). (The fact that they are not the same is the source of the "equity premium puzzle" into which we cannot go here.³)

The conventional wisdom is that the *expected real return* on US stocks averages between 7% and 9%. In contrast, the *expected real return* on US government bonds averages between 2% and 4%. We arrive therefore at the conventional equity premium of 8% - 3% = 5%.⁴ (Historically Canada's premium as been "substantially lower," but this may be changing.⁵)

3. What is the "normal" premium?

If the first dog a child encounters is a Great Dane, that child might have some difficulty with the concept "dog." Bull-market participants confronting a bear market face a similar conceptual problem, as we have already explained in our survey of behavioral finance (*FCC&C*, July 31, 2001). Many of today's market participants know only a bull market *without historical precedent*.

The fountainhead of our "normal" in the investment business, as Arnott and Bernstein helpfully identify for us, is the pioneering work by Roger Ibbotson and Rex Sinquefeld (n. 1, p. 82). The numbers 8% and 5%, cited above, are derived from this pioneering work, beginning with the seminal paper, "Stocks, Bonds, Bills and Inflation: Year-by-Year Historical Returns (1926-74)," *Journal of Business* 49.1 (January 1976): 11-47.

They go on to quote the 2001 update of the Ibbotson Associates data, the "bible" of the industry (i.e., from 1926 to 2001). The 2001 data indicate an average 11.0% nominal return on US stocks and a 5.3% nominal return on US bonds. The reported inflation rate is 3.1%. These numbers imply a *real return* on US stocks of 11.0% - 3.1% = 7.9% and a *real return* on bonds of 5.3% - 3.1% = 2.2%. The *implied equity risk premium* in 2001 was, therefore, 7.9% - 2.2% = 5.7%. "These data shape the expectations of the actuarial community, much of the

consulting community, and many fund sponsors.” (Notice that investors were expecting an average of 70 basis points *more* than the conventional figure of 5%.)

Arnott and Bernstein continue by claiming that such industry expectations are currently “unrealistic”; furthermore, and crucially, that such expectations have *always* been “unrealistic” in *any* market (with the exception of earth-shattering crises, world wars, etc.).

According to their calculations, over the two centuries of data, the historical average for the *prospective real return* on US stocks is 2.4% – i.e., a *third* of current industry expectations (8% ÷ 2.4%). Recall that this compares with the round figure of between 2% and 4% for expected real returns on US-government bonds. Such “uninspired pretax real returns,” they add, do not even take into account an expected *reversion to mean*, which would drive future stock returns even lower.

Furthermore, they describe the situation in early 2002 as “abnormal in the extreme” (p. 65). One should reasonably expect a *positive real premium* for stocks vs. bonds, given the relative volatility and the risks of defaulting. At times, the US equity premium has soared to 10%, give or take (during the Civil War, Great Depression, and after World Wars I and II). But today (read, early 2002) the premium is *below zero*, virtually without precedent (except for the late 1960s – an ominous precedent for equity enthusiasts).

4. What was “normal” in 1926?

A good deal of the Arnott and Bernstein paper deals with expectations at the start of 1926, when the roaring '20s began to roar. The year chosen, 1926, coincides with the beginning of the period covered by Ibbotson and Sinquefeld, as noted above (1926-1974). (Rhetorically, they are also trying to wean us from thinking the recent bull market was in any way “normal.”)

In 1926, US government bonds were returning 3.7%. The US was on the gold standard, and expected inflation was nil. Further, price levels appeared trendless. Therefore, in 1926 a reasonable expectation for real bond returns was 3.7%. The expected real return on US stocks was at that time equal to the dividend yield of 5.1%.⁶ Thus, at the beginning of 1926, the equity risk premium was approximately 5.1% – 3.7% = 1.4% (140 bps), crucially nowhere near our conventional 5%.

5. Abnormality and “historical accidents”

How, then, can we possibly arrive at our industry-standard figure of a 5% equity risk premium? Arnott and Bernstein argue that a series of “historical accidents” have skewed our expectations.

(1) Inflation has been a part of the post-WWII scene since countries went off the gold standard. This one-time shock to bonds, “decoupling” nominal from real yields, accounts for almost 10% of the excess.

(2) We have witnessed a fourfold increase in valuation multiples (from 18 to 70 times dividends), accounting for fully one third of excess returns.

(3) The US market is prone to “survivor bias,” since the US has not endured war and revolution on its soil. Four stock

markets, by way of contrast, those of China, Russia, Argentina, and Egypt, suffered a *total loss* of capital (i.e., a negative 100% return) in the past century (Germany and Japan came close). But in 1926, US investors would not have considered the risk of war or revolution to be zero (“nor should today’s true long-term investor” [p. 67]).

(4) Finally, roughly one quarter of the premium can be explained by regulatory reform, resulting in 1.4% growth of real dividends per annum.⁷

Doing the addition, and assuming that (3) is negligible for the US (Arnott, *pc*), we thereby account for about three-fourths of returns. The balance is made up by the risk premium.

6. Estimating expected real stock returns

The authors have found that the best predictor of real dividend growth is *real per capita GDP* (i.e., not growth *per se*, but growth in *productivity*). “The history of dividend growth shows no evidence that dividends can ever grow materially faster than the per capita GDP. Indeed, they almost always grow more slowly [70 bps difference]” (p. 73). Thus, if real per capita GDP growth were, for example, 3% and the population grew at 1%, then real dividend growth would be expected to be 2% per annum.

They make two noteworthy points under the rubric of stock returns. First, for the two centuries they studied, the reasonably *expected real return* to US stocks, according to their estimation, is 6.1%.⁸ They contrast this *prospective* 6.1% with the *retrospective actually earned real return* of 6.8%. Notice that this contrast emphasizes the difference, as noted above at the outset, between the *prospective*, or *ex ante*, *risk premium* and the *retrospective*, or *ex post*, *real excess return*. Unfortunately, the literature often labels both as simply the “premium.”

Second, from their assumptions and calculations, it follows that 85% (sic) of all stock returns over the past two centuries is attributable to their “historical accidents” *since 1982*. “Few observers have noticed that much of the difference between stock dividend yields and the real returns on stocks can be traced directly to the upward revaluation of stocks since 1982” (p. 71). They conclude, “Even if we adjust [as explained above] today’s 1.4 percent dividend yield sharply upward ..., making a case for real returns higher than the 3.4 percent currently [spring 2002] available in the TIPS market would be a stretch” (p. 71).

(N.B. To “adjust” the dividend yield on stocks to the expected real return on stocks, we must include the *change* in the real dividend (either plus or minus) and the *change* in valuation levels (again, either plus or minus), the latter typically measured in P/E multiples [p. 66].)

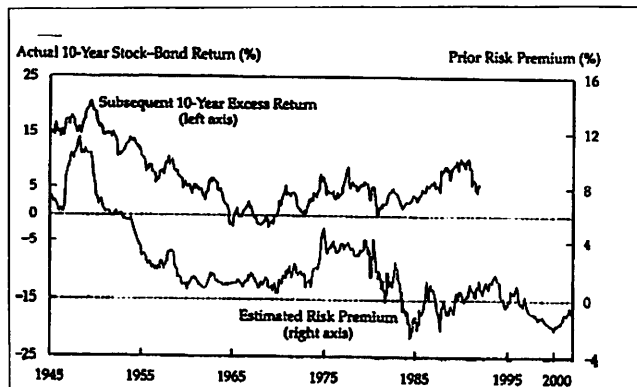
7. Estimating expected real bond returns

Since January 1997, the *expected real return* on US bonds has been the return to the US\$-denominated, inflation-indexed bonds, or TIPS.⁹ Previously, one would calculate the expected real return indirectly as the difference between the nominal yield on US Treasuries and the inflation rate: 4.9% – 1.2% = 3.7% (since 1802 to present). This implies that the forward-looking equity risk premium has historically been 6.1% – 3.7%

= 2.4%. (The *observed excess return*, however, was actually 3.3%. Arnott and Bernstein claim that the difference was due to the "historical accidents" listed above.)

Noteworthy is their illustration (see Chart 14), which shows that a gap between returns and expectations opened up in the 1990s, at the height of the bull market. We should assume that this gap implies a coming *correction* to close the gap, if history be any guide. "This reminder should be sobering to investors who are depending on a large equity risk premium" (p. 79).

Chart 14 - Risk premium and subsequent 10-year excess returns, 1945-2001



Courtesy AIMR

8. Conclusion

We therefore draw the following conclusions from the study by Arnott and Bernstein.

(1) The observed excess returns of stocks vs. bonds has recently been "extraordinary" and "abnormal" by historical standards. The authors attribute this result, as explained above, to "important nonrecurring developments" (i.e., their "historical accidents") in the last quarter of this century.

(2) It is dangerous in the extreme to extrapolate such "lofty historical returns."

(3) The objective, historical-average equity risk premium is approximately 2.4%.

(4) The implied US equity risk premium is currently 3%¹⁰ - 2.7% (TIPS) = 0.3%.

(5) Assuming, then, the premium of 0.3% as in (4), to shift back to the historical average of 2.4% in (3) would require either (i) a reduction of 210 basis points in the real bond returns to 0.6% or (ii) an offsetting reduction in stock valuations (thereby boosting expected returns by 2.1%) or (iii) some combination of (i) and (ii).

Arnott also writes the following in the First Quadrant *Client Newsletter* (10/2002 Partner's Message).

We think the natural yield for TIPS is below 2%, but that we might not get there in this market cycle. This gives us a 0.4% risk premium [0.3% at the end of March 2003] ... But should stocks only offer 0.4% more than government-guaranteed inflation-indexed bonds? Probably not. But, again, we may not get to a

sensible 1% to 2% level in this cycle (p. ii, cited by permission).

Two questions. First, what should we make of "probably not"? "Probably not" would entail stocks underperforming bonds for decades, with current stock valuations *cut in half*. Much more likely, then, is a Dow 3,600 than a Dow 36,000. (Do you still remember the bulls James Glassman and Kevin Hassett, authors of *Dow 36,000*, who argued that an equity risk premium is *no longer required*?)

Second, what might we expect if the GOP managed to pass a dividend tax cut? (Currently, the GOP is leaning to a tax cut that would expire in 10 years; cf. 2001 Bush tax cut.) Arnott expects equities to receive a bit of a boost for an approximately 1% risk premium (pc). Not much to write home about.

Notes

1. The author gratefully acknowledges the assistance of Rob Arnott, Chairman of First Quadrant. His replies to email queries were prompt and enlightening.

2. Analysts typically employ some variant of a "consumption-based" asset-pricing model introduced by R. E. Lucas in the 1978 *Econometrica* paper, "Asset Prices in an Exchange Economy." The valuation equation for stocks is given in (1) and for bonds in (2). The gross real rates of return are then given in (3) and (4). Finally, the difference or "equity premium" is given in (5).

$$(1) p_t = E_t m_{t+1} (p_{t+1} + d_{t+1})$$

$$(2) q_t = E_t m_{t+1}$$

$$(3) R_{t+1}^e = \frac{p_{t+1} + d_{t+1}}{p_t}$$

$$(4) R_{t+1}^f = \frac{1}{q_t}$$

$$(5) \text{equity risk premium} = R_{t+1}^e - R_{t+1}^f$$

Here, p_t and q_t are the prices of stocks and bonds respectively at time t , E is the mathematical expectations operator, m is the marginal rate of substitution, and d is the stock dividend. The gross real rate of return is R . (Source: *The New Palgrave Dictionary of Money and Finance* (1994).)

3. "If we distinguish between past excess returns and future expected risk premiums, the idea that future risk premiums should be different from past excess returns is not at all unreasonable" (p. 64).

4. Numbers vary somewhat. Wharton Professor Jeremy Segal, for example, reports an equity premium of 7% - 3.5% = 3.5%. (Inexplicably, *Businessweek Online* cited an equity risk premium of 9% (12/25/2000): perhaps they meant the real return on equity.)

5. Scot Blythe, "Equity Risk Premium in Canada May Go Higher," *Benefits Canada* (11/25/2002), quoting Rajiv Silgardo, chief investment officer at Barclays Global Investors

Canada. Silgado calculates a Canadian risk premium of 3.45% (exceeding his US premium by approximately 100 basis points).

6. That they were equal in 1926 may appear odd at first glance, but "investors were accustomed to the fact that company managers would often dilute shareholders' returns if an enterprise was successful but that the shareholder was a full partner in any business decline. More important was the fact that the long-run history of the market was trendless. Thoughts of long-term economic growth, or long-run capital appreciation in equity holdings, were simply not part of the tool kit for return calculations in those days" (col. 2, p. 66).

7. "Stocks have gone from passing relatively little economic growth through to shareholders to passing much of the

economic growth through to shareholders. This shift has led to 1.4 percent a year growth in real dividend payments and in real earnings since 1926. This accelerated growth in real dividends and earnings, which no one could have anticipated, explains roughly one-fourth of the 75-year excess return" (p. 67).

8. Here, 6.1% = "an expected yield averaging 5.0 percent plus real per capita GDP growth of 1.7 percent a year minus an expected *shrinkage* in dividends relative to real per capita GDP averaging -.06 percent" (p. 74).

9. Confusingly, TIPS originally stood for "Treasury Inflation-Protected Securities," but are currently referred to as "inflation-indexed" bonds.

10. Given an average 1.8% dividend yield plus a dividend growth rate of 1.2% = 3.0%.

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