



## THE CHAMELEON OF MADAGASCAR

by Glenn E. Atkins, CFA

Risk changes not only as to its reality, but also as to its expectations. That is, both actual and expected risk changes. Risk also moves and changes in its intensity. It moves from market sector to market

sector, from security to security and from country to country, among others.

Eventually the worst happens. Risk, like the chameleon from Madagascar, changes and moves so much that it completely blends into its surroundings such that you can't analyze it or even see it. Investors at that point are subconsciously aware of it, but in high numbers tend to ignore it in pursuit of greater investment return, much to their eventual chagrin.

I recently read a paper written by Howard Marks, Chairman of Oaktree Capital Management, LLC in Los Angeles entitled "The New Paradigm" that got me thinking. The general premise of his thesis is that too much capital is chasing too few alternative investments (hedge funds, collateralized debt obligations, credit default swaps, etc.), and there is no longer a focus of fundamental company research (the focus is rather on the structure of investment products, and that investors no longer appreciate what should be high expected risk). This is, in a word, complacency. No longer are normalized returns in the stock market (+10%) and bond market (5+%) acceptable. Investors are ever increasingly reaching for higher and higher returns, juiced up by leverage and financial engineering, to the point where they tend to ignore the direct relationship between risk and return. They fail to see and recognize the Chameleon of risk, even when it is looking right at them, hidden among the quest for, and disguised as the companion of, outsized returns. Risk and return are inextricably and forever linked.

A decade or so ago investors, institutional and especially the average individual, would never have dreamed of investing in a hedge fund. This realm was solely the reserve of the high-net-worth individual, risking his own (not somebody else's) capital that he could easily afford to lose. Credit default swaps (an insurance policy against a corporate bond defaulting) did not exist. Not much financial engineering existed, except the traditional stock option.

The market is now chasing exotic investment products, ignoring both the proverbial risk return trade-off, and traditional fundamental company research. Financial "products"

in today's market are being engineered ("manufactured") by Ph.d.'s in statistics and quantitative analysis, collectively and affectionately, the "quants." Marks cites an article from Grant's Interest Rate Observer that states "Financial engineering is the science of structuring cash flows; credit analysis is the art of getting paid."

These quants will take a pool of junk bonds, mortgages, bank loans, music royalties or other traditional or non-traditional securities and contractually slice and prioritize the cash flows emanating from these underlying securities and pay them out in the order of their contractual seniority. The result is that you can purchase a fully AAA rated (the rating agencies are complicit in this slicing of cash flows as well) security backed by nothing other than a diversified portfolio of junk bonds and the contractual promise that your slice of the pool will be paid first.

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You can also purchase the equity securities of this same pool and be guaranteed to be allocated the first losses to occur from the underlying securities. These equity securities are lovingly called "toxic waste", although they are much preferred by some risk-embracing investors and the returns can be quite high. Remember, it's OK to embrace risk on varying levels, just know how much risk you are taking and what you expect to be paid.

Where the quants step off the path of traditional investment analysis is that they don't care if one or a statistically insignificant number of the underlying securities go into default. They only care that the pool as a whole performs as expected and that the hierarchy of investors gets paid, down to and including the toxic waste equity piece. This whole conglomeration of financial engineering and restructuring of cash flows is nothing more than the traditional risk/interest rate arbitrage with a middleman. Guess who gets paid? The middleman. Oh yes, if the pool pays as expected everyone gets paid, and handsomely. The yields of each respective underlying slice of cash flow are higher than comparable securities with equal ratings. It has to be or no one would buy it.

There are many financial products in the investment market today, ranging from mutual funds, wrap accounts, annuities, and numerous variations of the ones mentioned earlier.

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## STATES' SHARE OF STOCK MARKET VALUE

by James B. Bell, CFA

Growing up in Arkansas, I was always impressed by the number and size of successful corporations in our state. I felt that their achievement was impressive for a state with a small population and an undeserved reputation for lack of progress. I felt that 'pound-for-pound', we would rank near the top of the list. Recently I decided to measure just where we fall in that spectrum, using the market capitalization of companies headquartered in each state per capita. The nearby map shows the results, with a darker color representing a higher market cap per capita.

Arkansas indeed is near the top of the list, ranking seventh among the 50 states and Washington, D.C. At a nearly \$200 billion market cap, Wal-Mart Stores is of course the company that pushes Arkansas up the list. But don't overlook Alltel, Murphy Oil, Windstream, Tyson Foods, J.B. Hunt, Dillard's, and Acxiom, all multi-billion dollar market cap companies as well. These and other companies combined with Arkansas' relatively small population (2,779,154 people according to the Census Bureau's 2005 estimate) produce a public market cap of \$90,510 per person, 62% higher than the national average of \$55,883.

At the top of the list is Washington, D.C. at \$217,698, which is somewhat of an anomaly. Although home to a number of large companies including Fannie Mae, Danaher, and Washington Post, this number is large more as a function of D.C.'s tiny population, only 550,521 people. Chances are that many of the employees of these companies live outside of Washington, D.C. proper.

Second on the list is Connecticut at \$184,571 per capita. Although not a populous state at

3,510,297 people, Connecticut is home to some of the country's largest companies, including conglomerates General Electric and United Technologies and insurance giants like Hartford and Aetna.

Also in the northeast are New York and New Jersey, numbers three and six on the list. New York is the financial capital of the U.S. and is home to the highest combined market cap of any state in the union including eight companies over \$100 billion. So despite being the third most populous state, New York still boasts \$145,280 per capita. Similarly, New Jersey is highly populated but home to many large companies, including many in the pharmaceutical and healthcare industries.

A surprise to some might be Nebraska and Minnesota at numbers four and five, respectively. Similar to Arkansas, Nebraska has a relatively small population but is home to Warren Buffett's insurance conglomerate Berkshire Hathaway, a behemoth that contributes heavily to Nebraska's \$126,684 per capita. Known for industriousness and innovation, Minnesota is home to companies such as UnitedHealth, U.S Bancorp, 3M, Medtronic, and Target.

At the bottom of the list is Wyoming, which has no public company with a market cap larger than \$90 million headquartered there. Wyoming is also our least populous state. In fact, you could probably win a bar bet with the knowledge that there are more people in Alaska than in North Dakota, Vermont, or Wyoming.

Rounding out the bottom five are other low population, lower market cap states: Alaska (home to two regional communications companies), West Virginia and New Mexico (both home to some banks and natural resource companies), and Vermont (Chittenden banks).

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The list is nearly endless. The commonality among the "products" of today is, guess what? A middleman. Granted, these products are all fine for many individuals and institutions in many situations. Indeed, there are many ways to skin the investment cat. No way, in isolation, is either right or wrong, only different.

For our money (and our clients') we'll stick to our knitting of fundamental investment analysis on individual securities. We'll create for each of our clients their own personalized and private mutual fund out of individual securities that represent only our best ideas. Occasionally, we'll use a mutual fund for international or

unique sector exposure. No middlemen, no products, no financial engineering. Investment analysis and security selection, pure and simple. We will never become complacent about risk. This approach has served both us and our clients well. What we do is not fancy. In fact, it's boring. Or with a slight twist on the old saying, it's not brain science or rocket surgery. Risk is always there. If you see it and understand it, risk can be managed. We will continue to focus our art, and our science for that matter, on getting paid and rewarded by the companies we own, not the products we sell or engineer. 🐘

